Fiscal Performance and Adjustment in the Pacific Island Countries: A Review

By

T.K. Jayaraman
School of Economics
The University of the South Pacific
Suva, Fiji

This paper presents work in progress in the School of Economics at USP. Comments, criticisms and enquiries should be addressed to the author.

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Abstract

The Pacific island countries (PICs) are vulnerable to external shocks including natural disasters. Aside from their economic openness, narrow range of exports and dependency on strategic imports, several of them faced adverse conditions during recent years such as fall in demand for primary commodities and services, including tourism. Furthermore, challenges of increased globalisation have been testing their capacity to withstand the risks imposed by the vulnerable nature of their economies. However, there are also notable examples of successful small states, which have overcome these handicaps by nurturing economic resilience through sound macroeconomic management. Fiscal policy plays a critical role in ensuring macroeconomic stability. This paper reviews recent trends in fiscal performance and investigates problem areas of fiscal adjustment, which require early attention.

1. Introduction

Small states in recent years have been facing adverse economic conditions, which have been hurting their growth and halting their progress towards achieving the Millennium Development Goals (MDGs). Notably, the average annual growth rates in per capita real income in many Pacific island countries (PICs) during the past decade (1995-2004) have been less than 2 percent, a rate which has been identified as the required growth rate for halving the incidence of poverty by 2015 (Dollar and Kraay 2001, AusAID 2005). External shocks including decline in terms of trade for primary exports, volatility in aid receipts as well as natural resource rent incomes such as revenue from fishing licenses, and higher than usual incidence of annual occurrences in recent years of natural disasters such as cyclones, apparently due to rise in global warming, have all been cited as reasons behind the lacklustre economic performance of small island states and in particular, in the Pacific region.

The impending discontinuance by the end of 2007 of the preferential treatment accorded by the European Union (EU) to sugar and other primary exports, hitherto enjoyed under various protocols and agreements for the past four decades, has also cast a shadow of gloom across the region. Despite a notice of more than five years given by EU for improving productivity at farm level and raising efficiency in processing at factory level towards enabling them to withstand competition from exporters from larger countries, PICs failed to quickly restructure their ailing export industries. Delays have thus proved
costly. Fall in export earnings of PICs with their usual high import penetration shares and little diversification into any manufacturing possibilities have been found responsible for the widening trade gaps as well (Browne 2006).

In these circumstances, nurturing economic resilience through maintaining macroeconomic stability as well as stepping up the rate of economic growth for raising per capita incomes has posed major challenges to PICs. They have been struggling to marshal all their available resources and trying to utilise the available policy tools, namely exchange rate, fiscal and monetary policies to promote growth and development. In the case of those PICs, who have chosen to adopt currencies of metropolitan countries as legal tender, there is much less manoeuvrability, as they have no control over exchange rates.

In pursuit of higher economic growth, expansionary fiscal policy measures in the midst of stagnant tax revenues, compounded by volatility in both aid inflows and natural resource rent incomes, have given rise to budget and external current account deficits. The emergence of twin deficits has been exercising considerable pressures on exchange rates as well. In these circumstances, fiscal adjustment measures are likely to be painful. Aside from slowing down their efforts toward realisation of MDGs., expenditure cuts have already fallen on critical components of expenditures, such as health and education, not to speak of the maintenance of existing physical assets. The objective of the paper is to undertake a review of the fiscal performance in PICs and evaluate their progress towards achieving a higher degree of nurtured resilience. The paper is organised as follows: the second section provides an overview of fiscal trends in PICs; the third section specifically evaluates fiscal adjustment measures in regard to expenditure controls, revenue mobilisation efforts and debt management; and the fourth and final section presents a summary.

2. Fiscal Trends in Pacific Island Countries

Among the 14 PICs, (Table 1 for the selected social and economic key indicators), which are members of the regional organisation, known as Pacific Forum, only one country, namely Papua New Guinea (PNG) has an independent, floating currency. Out of the remaining 13, eight PICs [Cook Islands, Federated States of Micronesia (FSM), Kiribati, Nauru, Niue, Palau, Republic of Marshall Islands (RMI), Tuvalu] are dollarised countries, having adopted the currencies of Australia, New Zealand or the United States. The rest (Fiji, Samoa, Solomon Islands, Tonga and Vanuatu) have independent currencies and their exchange rates are pegged to a composite basket of currencies of their major trading partners in accordance with the trade shares.

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1 For a detailed treatment of the topics on vulnerability and nurturing economic resilience of small states, see Briguglio (1995, 2004) and Jayaraman (2006).
### Table 1: Selected Key Economic and Social Indicators

<table>
<thead>
<tr>
<th>Countries</th>
<th>Population ('000) 2004</th>
<th>Area ('000) Sq.km</th>
<th>Per Capita GDP (Current Prices) 2004 in US$</th>
<th>Human Dev Index Ranking 2003</th>
<th>Vulnerability Index Rank 2000</th>
<th>Aid per capita in US$ 2004</th>
<th>% of GDP 1990</th>
<th>% of GDP 2004</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cook Islands</td>
<td>19</td>
<td>0.2</td>
<td>2,651</td>
<td>62</td>
<td>NA</td>
<td>490.0</td>
<td>NA</td>
<td>28.0</td>
</tr>
<tr>
<td>Fiji</td>
<td>841</td>
<td>18.3</td>
<td>2,720</td>
<td>92</td>
<td>8</td>
<td>76.0</td>
<td>3.9</td>
<td>2.6</td>
</tr>
<tr>
<td>FSM</td>
<td>110</td>
<td>0.7</td>
<td>2,300</td>
<td>120</td>
<td>NA</td>
<td>787.0</td>
<td>NA</td>
<td>36.0</td>
</tr>
<tr>
<td>Kiribati</td>
<td>98</td>
<td>0.7</td>
<td>970</td>
<td>129</td>
<td>59</td>
<td>171.0</td>
<td>22.5</td>
<td>17.8</td>
</tr>
<tr>
<td>Palau</td>
<td>20</td>
<td>0.5</td>
<td>6,870</td>
<td>NA</td>
<td>NA</td>
<td>978.0</td>
<td>NA</td>
<td>15.0</td>
</tr>
<tr>
<td>PNG</td>
<td>5,722</td>
<td>462</td>
<td>560</td>
<td>137</td>
<td>30</td>
<td>46.0</td>
<td>7.2</td>
<td>7.6</td>
</tr>
<tr>
<td>RMI</td>
<td>61</td>
<td>0.2</td>
<td>2,320</td>
<td>121</td>
<td>NA</td>
<td>836.0</td>
<td>49.6</td>
<td>37.4</td>
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<tr>
<td>Samoa</td>
<td>184</td>
<td>2.8</td>
<td>1,840</td>
<td>74</td>
<td>20</td>
<td>167.0</td>
<td>42.6</td>
<td>8.2</td>
</tr>
<tr>
<td>Sol.Is</td>
<td>468</td>
<td>28.9</td>
<td>560</td>
<td>128</td>
<td>11</td>
<td>262.0</td>
<td>21.7</td>
<td>47.8</td>
</tr>
<tr>
<td>Tonga</td>
<td>102</td>
<td>0.7</td>
<td>1,360</td>
<td>54</td>
<td>3</td>
<td>109.0</td>
<td>26.3</td>
<td>9.1</td>
</tr>
<tr>
<td>Tuvalu</td>
<td>11</td>
<td>0.003</td>
<td>345</td>
<td>118</td>
<td>NA</td>
<td>260.0</td>
<td>47.2</td>
<td>45.0</td>
</tr>
<tr>
<td>Vanuatu</td>
<td>207</td>
<td>12.2</td>
<td>1,390</td>
<td>118</td>
<td>1</td>
<td>162.0</td>
<td>33.0</td>
<td>12.4</td>
</tr>
</tbody>
</table>

Commonwealth Secretariat (2006)
Commonwealth Secretariat (2000)

### Dominance of Fiscal Policy

In the case of PICs, exchange rate regimes did not matter. Referring to inflation levels (Table 2) in the dollarised PICs, were not much different from those obtained in those PICs with independent currencies of their own, Rosales of IMF (2001) observed that there was nothing commendable about the choice of exchange rate regimes. The reason behind this phenomenon appears to be that all PICs have been sourcing their imports from Australia, New Zealand and the United States (US), whose central banks have been targeting inflation, which explains the low inflation in PICs.
Table 2: Pacific Island Countries:1995-2005
(Averages for the period Indicated)

<table>
<thead>
<tr>
<th>Countries</th>
<th>Real GDP Growth Rate</th>
<th>Inflation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cook Island</td>
<td>3.0</td>
<td>4.3</td>
</tr>
<tr>
<td>Fiji</td>
<td>2.3</td>
<td>2.6</td>
</tr>
<tr>
<td>Kiribati</td>
<td>3.0</td>
<td>-0.2</td>
</tr>
<tr>
<td>FSM</td>
<td>-.</td>
<td>0.9</td>
</tr>
<tr>
<td>Palau</td>
<td>2.8</td>
<td>1.4</td>
</tr>
<tr>
<td>PNG</td>
<td>1.1</td>
<td>1.7</td>
</tr>
<tr>
<td>RMI</td>
<td>-0.6</td>
<td>3.0</td>
</tr>
<tr>
<td>Samoa</td>
<td>4.1</td>
<td>4.2</td>
</tr>
<tr>
<td>Solomon Is</td>
<td>-0.04</td>
<td>0.8</td>
</tr>
<tr>
<td>Tonga</td>
<td>2.2</td>
<td>2.1</td>
</tr>
<tr>
<td>Tuvalu</td>
<td>2.9</td>
<td>6.4</td>
</tr>
<tr>
<td>Vanuatu</td>
<td>2.2</td>
<td>0.4</td>
</tr>
</tbody>
</table>

Source: UNESCAP (2006)

It is well known that under fixed exchange rate regimes, the role of monetary policy is generally found to be less effective. In the past, existence of exchange controls had enabled monetary policy to be of some use (Khatkhate and Short 1980). With increased liberalisation since the late 1980s, and near total dismantling of exchange controls especially in regard to current account, monetary policy is not likely to play any effective role. Further, with nascent money and capital markets in all PICs, transmission mechanism has been found to be weak. A recent study on the effectiveness of fiscal and monetary policies on Fiji’s economic growth covering a period of 30 years (1970-2002)\(^2\) found absence of any relationship in the short-run between monetary policy and economic growth, although there existed a long-term relationship between growth and fiscal and monetary policies. In the short run, economic growth of Fiji was positively influenced only by fiscal policy (Dahalan and Jayaraman 2006).

It is often touted that dollarisation, namely adopting the currency of a major trading partner as legal tender, would instil fiscal discipline in the decision makers of a small country as it eliminates the possibility of resorting to printing money at will for financing budgetary excesses, known as “fiscal abuse” of the central bank (Fry 1993). Regardless of the fact whether or not the country concerned has an independent currency of its own, fiscal policy has been the foremost policy tool\(^3\) for PICs. What is striking is that overall

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\(^2\) The study, which covered a period of 33 years (1970-2002) employed real government expenditure and real net foreign assets respectively representing fiscal policy and monetary policy and adopted the bounds testing procedure advanced by Pesaran et al. (2001).

\(^3\) The findings by Easterly and Rebelo (1993) in their study of advanced countries are relevant for PICs as well. They are (i) the share of public investment in transport and communications is robustly correlated with growth in income; (ii) the government’s budget surplus is correlated with growth in income and
fiscal balances\(^4\) of all PICs, with the exception of RMI, which along with two other former UN Trust Territories administered by the US has been receiving substantial funds for budget support under the Compacts of Free Association (the Compact) from the US\(^5\), have all been found negative (Table 3).

| Table 3 : PICs: Government Revenue, Expenditure and Overall Balance (Averages and Variability) |
|---------------------------------|---------------------------------|----------------|----------------|----------------|----------------|----------------|
|                                 | Govt Rev (% of GDP) Average     | Govt Rev Standard Deviation | Govt Exp (% of GDP) Average | Govt Exp Standard Deviation | Overall Bal (% of GDP) Average | Overall Bal Standard Deviation |
| 1988-2005                       |                                 |                             |                              |                              |                                |                                |
| Fiji                            | 26.4                            | 2.4                         | 30.5                         | 2.2                         | -4.1                         | 1.8                         |
| FSM                             | 71.6                            | 10.2                        | 73.9                         | 10.7                        | -2.3                         | 53.0                        |
| Kiribati                        | 111.6                           | 20.1                        | 122.7                        | 23.4                        | -11.1                        | 19.9                        |
| PNG                             | 24.7                            | 3.9                         | 30.2                         | 2.5                         | -5.5                         | 1.9                         |
| RMI                             | 68.8                            | 9.2                         | 64.2                         | 11.1                        | 4.6                          | 11.2                        |
| Samoa                           | 38.5                            | 6.7                         | 41.9                         | 14.9                        | -3.4                         | 7.2                         |
| Sol. Is                         | 24.5                            | 3.2                         | 36.3                         | 2.8                         | -11.8                        | 3.5                         |
| Tonga                           | 29.8                            | 2.6                         | 30.4                         | 3.1                         | -0.6                         | 3.7                         |
| Vanuatu                         | 22.3                            | 2.3                         | 28.2                         | 6.5                         | -5.9                         | 3.2                         |
| 1988-1999                       |                                 |                             |                              |                              |                                |                                |
| Fiji                            | 26.8                            | 2.7                         | 30.4                         | 2.6                         | -3.6                         | 2.0                         |
| FSM                             | 77.2                            | 4.3                         | 80.4                         | 5.9                         | -3.2                         | 4.1                         |
| Kiribati                        | 103.7                           | 20.7                        | 107.7                        | 9.8                         | -4.0                         | 16.9                        |
| PNG                             | 23.9                            | 1.7                         | 30.1                         | 2.6                         | -6.2                         | 2.0                         |

\(^4\) We use in this paper overall balance (total government revenue including grants minus total expenditure including interest payments) rather than primary balance ((total government revenue including grants minus total expenditure excluding interest payments). Primary balance, which reflects the country’s fiscal effort (Daniel et al. 2006) to generate surpluses (Sahay 2005), would have been ideal, as it is a critical variable for debt sustainability analysis. Since data on interest payments are not specifically available on a time series basis for all PICs, overall balance figures are used. Secondly, one single source, (IMF 2006a and 2006b) for data comparison among PICs is drawn upon.

\(^5\) RMI along with Federated States of Micronesia (FSM) and Palau, which were once United Nations Trust Territories and administered by the United States, have been receiving assistance from the US under respective Compacts of Free Association (the Compact) ever since they became independent sovereign nations. Under Compact I (1986-2001), RMI received US$ 640 million, which covered the government recurrent and capital expenditures. Under Compact II, (2004-2023), RMI would continue to receive US $42.7 million (nearly 40 percent of GDP). Similarly, FSM under Compact I (1987-2001), received annual cash grants of US$ 97.9 million during 1987-91, $91.1 million during 1992-96 and US$ 79.2 during 1997-2001. Under Compact II (2004-2023), FSM would receive US $92.7 million per year. Palau, which became independent in 1994, is now covered under a 50-year Compact during which it would receive nearly US$ 620 million.
Structural rigidities in budgets

The primary reason behind the persistent fiscal deficits in PICs can be attributed to structural rigidities in their budgets. The revenue resource bases are narrow in all PICs. Being dependent on taxes on imports and exports, government revenues, which include grants, are subject to volatility. Direct tax revenues of PICs average about 17 percent to 25 percent of GDP each year. Vanuatu does not have direct taxation of any kind, either on personal or corporate income or estate duty. Consequently, it has to depend only on indirect taxes, dominated by taxes on consumption of goods and services, excise and value added taxes (VAT), besides taxes on international trade. In other PICs, direct taxes, except for PNG, bring in less than 10 percent of GDP (Table 4). The shares of nontax revenues in GDP are much larger in Kiribati and Tuvalu. They ranged from 50 percent to 54 percent. In 2006, fishing license fees accounted for 87 percent of Kiribati’s nontax revenues in 2006 and 43 percent of total government revenues. Since resource rent income receipts varied from year to year, we observe high volatility in total government revenues of Kiribati. In the case of Compact countries, the grants received from the US being a larger component of revenue receipts, total government revenues as proportions of GDP are much higher, ranging from 69 percent in case of RMI to 72 percent in Palau.

On the expenditure front, the structural rigidities have been equally insurmountable. They emanate from the traditional image of the government being the biggest employer in the formal sector as well as provider of services. Table 3 presents government expenditures as proportion of GDP. The high ratios in PICs such as Kiribati (123 percent), FSM (74 percent), and RMI (84 percent) during 1988-2005 reflect the situation that PICs with

<table>
<thead>
<tr>
<th></th>
<th>2000-2005</th>
<th></th>
<th>2000-2005</th>
</tr>
</thead>
<tbody>
<tr>
<td>RMI</td>
<td>74.2</td>
<td>4.6</td>
<td>67.6</td>
</tr>
<tr>
<td>Samoa</td>
<td>31.8</td>
<td>7.4</td>
<td>47.2</td>
</tr>
<tr>
<td>Sol. Is</td>
<td>20.9</td>
<td>4.3</td>
<td>35.7</td>
</tr>
<tr>
<td>Tonga</td>
<td>28.2</td>
<td>1.1</td>
<td>29.3</td>
</tr>
<tr>
<td>Vanuatu</td>
<td>20.3</td>
<td>0.9</td>
<td>23.9</td>
</tr>
<tr>
<td>Fiji</td>
<td>25.3</td>
<td>0.9</td>
<td>30.3</td>
</tr>
<tr>
<td>FSM</td>
<td>63.5</td>
<td>9.1</td>
<td>65.0</td>
</tr>
<tr>
<td>Kiribati</td>
<td>120.7</td>
<td>16.5</td>
<td>140.2</td>
</tr>
<tr>
<td>PNG</td>
<td>26.4</td>
<td>6.4</td>
<td>30.4</td>
</tr>
<tr>
<td>RMI</td>
<td>64.3</td>
<td>9.9</td>
<td>61.2</td>
</tr>
<tr>
<td>Samoa</td>
<td>33.0</td>
<td>1.1</td>
<td>34.9</td>
</tr>
<tr>
<td>Sol. Is</td>
<td>28.2</td>
<td>4.4</td>
<td>30.6</td>
</tr>
<tr>
<td>Tonga</td>
<td>30.5</td>
<td>2.7</td>
<td>32.3</td>
</tr>
<tr>
<td>Vanuatu</td>
<td>23.4</td>
<td>2.1</td>
<td>30.4</td>
</tr>
</tbody>
</table>

Source: Author’s Calculations
small population are less able to realise scale economies in the provision of public goods and services. These PICs are also recipients of high per capita aid, which facilitate funding of larger public sectors. A study by the US General Accounting Office reported that the funds under the first Compacts in case of RMI and FSM mainly financed government consumption and high government wages and the purpose behind the Compact of enabling the two countries reaching self-sufficiency and self-reliance could not be achieved.

Although reforms have begun in the late 1990s with a view to trimming the civil service, public sector wage bill has continued to remain high. For example, in Fiji, which witnessed the introduction of reforms in the late 1980s, following the two coups in 1987, the wages and salaries component has still been around 45 percent of the total expenditure. The operating expenditures, which are dominated by wages and related travel and other housekeeping expenses, are about 80 percent of total expenditure. Such a high proportion of total expenditures have eaten into government resources, denying greater allocation to more critically needed investments in growth enhancing capital projects (Jayaraman and Choong 2006a).

Fiscal Vulnerability Indicators

Table 4, which presents some of the fiscal vulnerability indicators, shows that overall fiscal balances have been negative for all countries, except RMI which, as noted earlier, has been receiving substantial aid under the Compact I and II. The highest average negative overall balance during the last six-year period (2000-2005) was recorded in the case of Kiribati (20 percent of GDP), followed by Vanuatu (7 percent of GDP) and Fiji (5 percent of GDP). While fiscal deficits were financed in Kiribati by substantial drawdown from Revenue Equalisation Reserve Fund (RERF) and in Tuvalu by similar recourse to Tuvalu Trust Fund (TTF), Fiji’s fiscal deficits were financed entirely by domestic borrowing until 2005. In September 2006, for the first time Fiji resorted to external borrowing in the international bond market for financing the budget deficit.

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6 The RERF was set up in 1956, for receiving and holding royalties collected from phosphate mining companies. The RERF funds were invested in overseas securities. In 1996, the parliament laid down that value of RERF per capita should be kept constant for future generations. The market value of RERF rose from AS 97.1 million in 1984 to AS666 million in October 2006 (ADB 2007). Between 1997 and 2007, annual average drawdowns were limited to 5.6 percent of GDP and value of RERF assets per capita rose in real terms by 55 percent. Expansionary fiscal spending during next three years led to heavy drawdowns from RERF, as it reached 25 percent of GDP (Feyzioglu 2006).
<table>
<thead>
<tr>
<th>Country</th>
<th>2001</th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
<th>2005</th>
</tr>
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<tbody>
<tr>
<td>Fiji</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Revenue &amp; Grants</td>
<td>22.1</td>
<td>24.6</td>
<td>25.1</td>
<td>25.8</td>
<td>25.8</td>
</tr>
<tr>
<td>Expenditure &amp; Net Lending</td>
<td>28.6</td>
<td>31.6</td>
<td>31.1</td>
<td>29.1</td>
<td>29.6</td>
</tr>
<tr>
<td>Overall Balance</td>
<td>-6.5</td>
<td>-7.0</td>
<td>-6.0</td>
<td>-3.3</td>
<td>-3.8</td>
</tr>
<tr>
<td>Government Debt</td>
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<td>48.0</td>
<td>49.0</td>
<td>53.0</td>
<td>52.0</td>
</tr>
<tr>
<td>External Debt</td>
<td>13.6</td>
<td>13.7</td>
<td>12.2</td>
<td>10.9</td>
<td>11.1</td>
</tr>
<tr>
<td>Current Account Balance</td>
<td>-3.5</td>
<td>-1.7</td>
<td>-2.0</td>
<td>-5.0</td>
<td>-4.5</td>
</tr>
<tr>
<td>Intl.Reserves (months of imports)</td>
<td>4.3</td>
<td>3.5</td>
<td>3.1</td>
<td>3.3</td>
<td>3.5</td>
</tr>
<tr>
<td>Exch Rate (Dom.currency/US$)</td>
<td>2.3</td>
<td>2.2</td>
<td>1.9</td>
<td>1.7</td>
<td>1.7</td>
</tr>
<tr>
<td>Kiribati</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Revenue &amp; Grants</td>
<td>118.4</td>
<td>138.7</td>
<td>139.2</td>
<td>106.2</td>
<td>123.2</td>
</tr>
<tr>
<td>Expenditure &amp; Net Lending</td>
<td>135.4</td>
<td>139.3</td>
<td>171.0</td>
<td>149.0</td>
<td>145.8</td>
</tr>
<tr>
<td>Overall Balance</td>
<td>17.0</td>
<td>0.6</td>
<td>-31.9</td>
<td>42.8</td>
<td>-22.6</td>
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<tr>
<td>External Debt</td>
<td>20.0</td>
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<td>19.0</td>
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<td>Current Account Balance</td>
<td>2.0</td>
<td>-1.8</td>
<td>-19.3</td>
<td>-16.3</td>
<td>-9.4</td>
</tr>
<tr>
<td>Exch Rate (Dom.currency/US$)</td>
<td>1.9</td>
<td>1.8</td>
<td>1.5</td>
<td>1.4</td>
<td>1.3</td>
</tr>
<tr>
<td>Marshall Islands</td>
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<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Revenue &amp; Grants</td>
<td>70.1</td>
<td>64.2</td>
<td>65.0</td>
<td>56.2</td>
<td>58.1</td>
</tr>
<tr>
<td>Expenditure &amp; Net Lending</td>
<td>61.9</td>
<td>68.2</td>
<td>54.0</td>
<td>56.6</td>
<td>60.2</td>
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<tr>
<td>Overall Balance</td>
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<td>-4.0</td>
<td>11.0</td>
<td>-0.4</td>
<td>-2.1</td>
</tr>
<tr>
<td>External Debt</td>
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<td>71.2</td>
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<td>70.6</td>
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<tr>
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<tr>
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<td>1.0</td>
<td>1.0</td>
<td>1.0</td>
<td>1.0</td>
</tr>
<tr>
<td>Micronesia</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Revenue &amp; Grants</td>
<td>64.2</td>
<td>71.8</td>
<td>71.8</td>
<td>53.7</td>
<td>51.0</td>
</tr>
<tr>
<td>Expenditure &amp; Net Lending</td>
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<td>63.8</td>
<td>58.6</td>
<td>54.2</td>
</tr>
<tr>
<td>Overall Balance</td>
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<td>6.8</td>
<td>7.9</td>
<td>-4.8</td>
<td>-3.2</td>
</tr>
<tr>
<td>External Debt</td>
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<td>25.6</td>
<td>25.2</td>
<td>25.8</td>
<td>24.8</td>
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<tr>
<td>Current Account Balance</td>
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<td>7.3</td>
<td>0.9</td>
<td>-10.6</td>
<td>-12.1</td>
</tr>
<tr>
<td>Exch Rate (Dom.currency/US$)</td>
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<td>1.0</td>
<td>1.0</td>
<td>1.0</td>
<td>1.0</td>
</tr>
<tr>
<td>Palau</td>
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<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Revenue &amp; Grants</td>
<td>43.1</td>
<td>42.4</td>
<td>54.0</td>
<td>54.3</td>
<td>53.6</td>
</tr>
<tr>
<td>Expenditure &amp; Net Lending</td>
<td>64.6</td>
<td>66.3</td>
<td>62.6</td>
<td>61.7</td>
<td>54.2</td>
</tr>
<tr>
<td>Overall Balance</td>
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<td>-28.3</td>
<td>-2.4</td>
<td>-6.9</td>
<td>-3.9</td>
</tr>
<tr>
<td>External Debt</td>
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<td>16.6</td>
<td>15.9</td>
<td>14.0</td>
<td>13.2</td>
</tr>
<tr>
<td>Current Account Balance</td>
<td>-9.4</td>
<td>-11.0</td>
<td>9.6</td>
<td>12.6</td>
<td>15.1</td>
</tr>
<tr>
<td>Exch Rate (Dom.currency/US$)</td>
<td>1.0</td>
<td>1.0</td>
<td>1.0</td>
<td>1.0</td>
<td>1.0</td>
</tr>
</tbody>
</table>
In the past two decades, central bank financing of fiscal deficits was not uncommon. Deficits in PNG, Solomon Islands, and Vanuatu were financed through central bank borrowing. For example, PNG’s large budget deficits of the mid 1990s, which were incurred due to defence spending on Bougainville, tax reductions, agricultural subsidies, and persistent expenditure overruns, were duly monetised by its central bank. The central bank autonomy was established by a much needed legislation only much later in 2000 (Marciniak 2006). In Vanuatu, the un-subscribed government bonds for financing the purchase of an aircraft for the government-owned airline, Air Vanuatu, were picked up by Reserve Bank of Vanuatu (Jayaraman 1998). Restoration of central bank autonomy through legislation as well as greater appreciation of the need for administrative measures to promote fiscal and monetary policies coordination (Ali and Jayaraman 2001) in the later part of last decade, seem to have lessened the incidence of monetisation of fiscal deficits in recent years.

**Financing Fiscal Deficits**

Consequently, PICs now look to the usual avenues of funding fiscal deficits, which are domestic public borrowing and loans from external funding agencies. Fiji, which is above the threshold level of income per capita, is not eligible for borrowing on concessional terms from international funding agencies including Asian Development Bank and the World Bank. However, those PICs, which are eligible for loans on soft terms, took considerable advantage of such facilities. The result is that government debt for most PICs like Samoa is external. Although Samoa’s government debt is seemingly high at 50 percent of GDP in 2005, its debt burden was relatively small, since debt-servicing costs were below 8 percent of exports of goods and services. On the other hand, Fiji financed its fiscal deficits by domestic borrowing, mostly from the National Provident Fund, continuously for a six-year period (2001-2006). Fiji’s total government debt in 2006 was 53 percent of GDP. With contingent liabilities such as guaranteed debt of state owned enterprises and other undertakings, the debt ratio was higher at around 60 percent of GDP.

**External Debt**

Fiji’s external debt was all along kept deliberately low at around 10 percent of GDP until 2006, by its past policies of minimal borrowing from international funding agencies. Utilising the favourable credit rating, Fiji carried out its first ever bond issue in international bond markets in September 2006, the issue size being at US$ 150 million with the stated objective that the loan proceeds would be for meeting the 2007 budget deficit requirements. The bond maturity period was for five years and the coupon payment amounted to 7 percent of the face value.

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7 Fiji’s credit rating had, however, fallen since December 2006 due to military coup and continuing distrust in the interim government by the international community. The price of the bond fell from US$ 99.80 (face value of US$ 100) to US$ 86. In late 2006, the Standard & Poor’s lowered Fiji’s foreign currency and local credit rating to B+ and BB- from BB+ and BB respectively. In March 2007, the ratings were further lowered to B and B+ respectively (RBF 2006b).
Fiscal deficits either funded by continuous borrowing or by drawing down funds from trust funds pooling the resource rents, leads to rise in aggregate demand, which eventually spills over into demand for foreign goods and services. But for substantial aid inflows and remittances, current account balances in several PICs would have become negative. Since Fiji is not a major recipient of aid (Table 1), as it does not exceed more than 3 percent of GDP, current account imbalances during 2001-2005, became regular and were growing, despite a surge in annual remittances since 2003. Table 5 presents figures relating to budget, trade and current account deficits during 2000-2004. With the exception of PNG, which ran trade surplus due to commodity price booms in recent years, and Solomon Islands, which received substantial aid during 2001-2004, the other four major island countries experienced sizeable current account deficits.

*Twin Deficit Hypothesis*

Although empirical evidence obtained elsewhere is not conclusive enough to establish the popular twin deposit hypothesis that fiscal developments are the driving force behind trends in current account balances (IMF 2001, Chinn and Prasad 2000, Normandin 1999, Darrat 1988), two recent studies in regard to PICs (Jayaraman and Choong 2007b, 2007c) have shown the existence of twin deficits in Fiji and Vanuatu. While the persistent fiscal deficits were financed from increased public borrowing, the current account deficits were financed under fixed exchange rate regimes by a steady drawdown from the international reserves. Fiji’s reserves position weakened gradually from 2002 (6.3 months of import cover) to 2006 (3.2 months of imports cover).

### Table 5: Budget, Trade and Current Account Deficits of Selected Countries: 1990-2004

<table>
<thead>
<tr>
<th>PICs</th>
<th>Budget Deficit Average (% of GDP)</th>
<th>Trade Deficit Average (% of GDP)</th>
<th>Current Acct Deficit Average (% of GDP)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fiji</td>
<td>3.2 3.2 5.1</td>
<td>14.4 11.6 17.0</td>
<td>2.1 0.2 7.0</td>
</tr>
<tr>
<td>PNG</td>
<td>3.7 0.8 1.5</td>
<td>-14.7 -21.0 -26.5</td>
<td>-3.8 -4.6 -4.3</td>
</tr>
<tr>
<td>Samoa</td>
<td>10.5 0.2 1.3</td>
<td>68.3 38.7 41.4</td>
<td>13.2 -5.0 0.2</td>
</tr>
<tr>
<td>Solomon Is</td>
<td>6.1 0.9 5.8</td>
<td>0.9 -2.1 1.1</td>
<td>6.6 -1.1 -1.4</td>
</tr>
<tr>
<td>Tonga</td>
<td>0.0 1.1 1.1</td>
<td>30.0 -2.1 35.1</td>
<td>-1.5 6.7 2.2</td>
</tr>
<tr>
<td>Vanuatu</td>
<td>4.6 3.2 2.7</td>
<td>30.3 20.2 23.8</td>
<td>7.2 8.8 4.6</td>
</tr>
</tbody>
</table>

Source: ADB 2006; Authors’ calculations
As Fiji’s international reserves were seen declining from 2002 onwards for the next four years, pressures were mounting on the exchange rate during the second half of 2006 resulting in speculative attacks, as rumours were rife about imminent devaluation. It was then clear that fiscal deficits and the build up of public debt of record size would eventually take a toll on the country’s currency (Jayaraman and Choong 2006c). Fiji’s monetary authority, the Reserve Bank of Fiji (RBF) imposed in December 2006, exchange controls on transactions under capital account and introduced credit ceilings along with increases in interest rates on RBF lending facilities to commercial banks (RBF 2006c).

**Characteristics of Macroeconomic Instability**

Fiji’s macroeconomic situation of 2006 was similar to the on that prevailed in PNG in the 1990s. The PNG pursued expansionary fiscal policies during the four years preceding the 1997 general elections, which included tax reductions, agricultural export subsidies, persistent expenditure excesses, and regular transfers to unviable state owned enterprises and as a result there were massive annual budget deficits in a row. PNG’s government debt rose to 60 percent of GDP in 1996 from 45 percent in 1990. Balance of payment crises ensued and the international reserves dwindled at one point to a half-month of non-mineral imports (Marciniak 2006). Events forced PNG to resort to a floating exchange rates regime, which brought in a measure of external stability, though only for a short period. Sharp contraction in exports due to drought in 1997 and Asian financial crisis caused another current account crisis. Budgetary reforms introduced in 1999 restored some stability. However, in the months leading up to the 2002 elections, the familiar fiscal excesses were again indulged in by the incumbent government to re-capture power, which led to deterioration of both budget and current account balances. After three years of negative growth, PNG’s economy picked up in 2005, which was aided by sensible policies and export boom. PNG’s international reserves position improved and reached record levels higher than at 5 months import cover.

The case of Solomon Islands is similar to that of PNG as well. The country experienced three decades of fiscal imbalances since becoming independent in 1978. The reasons were stagnant revenues, often eroded into by tax and customs exemptions and rise in current expenditures due to increase in wages and salaries, transfers to local governments and inadequate expenditure controls. The short lived recovery on current account in the balance of payments during the first half of the 1990s was primarily attributed to unprecedented logging and timber exports, which did not last long. The ethnic conflict of
1999 and its aftermath, resulted in negative growth for the next three years. Fiscal deficit due to fall in revenues consequent to decline in exports induced by the Asian financial crisis of 1998 and civil strife was at its highest (12 percent of GDP) in 2001. The international reserves position was at the weakest level (2 months of import cover) in 2001. The economy recovered soon after the Regional Assistance Mission to Solomon Islands led by Australia and other donors was mounted in 2003. Bilateral donors on behalf of Solomon Islands settled the outstanding debt servicing obligations to international funding agencies. Improvements in fiscal management since 2003 stabilised the economy and the fiscal position improved thereafter.

Thus, PICs are grappling with grave issues of macroeconomic instability since the beginning of the new Millennium due to expansionary fiscal policies. Stagnation in government revenues, fall in natural resource rent incomes and declining aid inflows have further compounded the problem of growing fiscal deficits. These deficits, financed first by domestic borrowing including central bank credit and later by overseas borrowing, have serious repercussions on balance of payments, not very dissimilar to the ones observed in the Caribbean context in the mid 1990s (Hilaire 2000). These include external current accounts slipping into deficits, followed by the plummeting of foreign reserves, with spectre of default on foreign loans looming and exchange rates being under threat. In these circumstances, the only way out appears to be launching a programme of fiscal adjustment carried out in a sustained manner in the medium term. Although such efforts were initiated earlier in several PICs, they were often disrupted by the after-impact of unforeseen natural as well as man-made disasters, including coups. As noted by Khamfula (2005) in his study on African countries, exogenous shocks, which are often the major cause of economic volatility in small island states, have to be reckoned with as they endanger fiscal reform programmes.

3. Fiscal Adjustment: Past Performance and Future Prospects

In the current context of persistent twin deficits in PICs, the standard remedy (Daniel et al. 2006) is fiscal adjustment, which is expected to facilitate external adjustment as well (Easterly et al. 1994). Giving a broader definition, Daniel et al. (2006) clarify that fiscal adjustment would mean change in fiscal stance, either tightening or loosening, as the situation would warrant. The term fiscal consolidation, with reference to twin deficits, has a direct connotation, as it would imply reducing government deficit and debt accumulation.

Fiscal Consolidation

Reducing government spending, as a remedy to reduce annual fiscal imbalances and accumulation of debt has not been found as easy as expansionary spending. This was borne by public reactions in March 2007 to the initiatives announced by the interim government in Fiji with a view to put an end to the six-year (2001-2006) non-stop expansionary fiscal spending through heavy public borrowing in each of the six years, which led to depletion of foreign exchange reserves and exercised considerable pressures on Fiji’s pegged exchange rate (Jayaraman and Choong 2007a, 2006c). The fiscal
consolidation measures, which were indicated in the interim government’s revised budget for 2007, included reduction in the operating expenditures through trimming the number of ministries and departments from 36 to 16, by cuts in wages and salaries of civil servants by 5 percent across the board and by downsizing the civil service size through lowering the retirement age limit from 60 to 55 and freezing the vacant positions. Public reaction was that reduction in government spending would lead to recession. It was argued that if government applied brakes on public spending, even in pursuit of a well-intentioned attempt to balance the budget, the fall in aggregate demand would lead to unemployment and there would be an economic slow down.

Experiences in Industrial Countries

Such fears were no doubt genuine, as the impact in the short-run has the potential to trigger a recession. However, recent empirical investigations of fiscal expansion and consolidation experiences in industrial countries (McDermott and Westcott 1996a) have shown that fears of a slowdown in the short-run would be offset by gains in the long run. The non-Keynesian economic literature based on neoclassical models (IMF 1996, Giavazzi and Pagano 1990, Alesina and Perotti 1995a) argued that sustained fiscal adjustment in terms of budget and debt reduction would result in lower interest rates, exchange rate depreciation and give rise to “positive expectational effects” that would even swamp the traditional undesirable effects of fiscal contraction such as unemployment and recession (McDermott and Westcott 1996b).

The argument in favour of reduced government spending runs on the following lines: (i) a smaller budget would reduce the perceived risk that a government might depreciate its debt through high inflation in the future (paying off debt with cheaper money); (ii) a reduction in the perceived risk would then lead to fall in interest rates; and (iii) this will be followed by reduction in default risk premium interest rates, as budget reduction would improve the image of government in terms of its solvency. It is further argued that compression of public expenditure especially through reduced public salaries and wages, would also have an impact on private salaries and wages as well and hence would raise profitability and competitiveness, thus stimulating investment and exports (IMF 2001, Alesina et al. 1999); and that budget reduction would send out signals to households and businesses alike that future tax burdens would be lowered, as debt financing by government would fall and consequently households would increase their consumptions and businesses would increase their investment spending and the eventual outcome would be an increase in output.\(^8\)

There are no studies on impact of fiscal adjustment in PICs, comparable to McDermott and Westcott (1996). The apparent reason is that such fiscal adjustment measures were not implemented on a sustained scale as in industrial countries. However, an important study by Gupta et al. (2004) on the persistence of fiscal adjustments in 29 developing

\(^8\) While noting that the non-Keynesian effects were important in those euro area countries characterized by high levels of government debt and large public sectors, IMF studies (1996, 2001) observed the impact of reduced fiscal spending on output in the short term is an area of some dispute.
countries in different regions under the IMF supported programmes in the 1990s show that persistence of fiscal adjustment is (i) positively determined by certain factors which include reallocation of recurrent expenditures to productive capital projects; and (ii) negatively influenced by large outlays of wages and salaries.

The fiscal adjustment measures include: (i) effective expenditure control and budget–monitoring; (ii) efficient revenue system; (iii) improved measures for responding to frequently variable non-tax revenue receipts and volatile aid inflows; (iv) re-directing aid moneys into capacity building investments by streamlining civil service and reducing recurrent expenditures; (v) careful debt-management; and (vi) improving foreign earnings from limited range of exports and services including tourism, by maintaining a competitive real exchange rate so that external debt servicing does not pose problems in the long run.

*Effective Expenditure Control*

Since revenue mobilization in PICs is seriously constrained by structural rigidities, such as narrow revenue base with heavy dependence on international trade taxes, fiscal consolidation efforts will therefore, have to begin from and concentrate on effective expenditure adjustments. One of the steps required is to reduce the wage bill. Since government is the major employer in the formal sector in the region, there is always a reluctance to downsize the civil service, with ghost-employees on its roll and high rate of absenteeism. Although it is being increasingly realized that a leaner civil service with adequate remuneration and incentives could be more efficient and productive, the ongoing efforts are half-hearted, as any retrenched people are re-employed elsewhere in the civil service in newly created departments or shifted to state owned enterprises.

As regards budgetary exercises, forward estimates have been unrealistic: either underestimates in regard to operating and maintenance of existing productive assets or overestimates for new capital projects. The PICs are “littered literally with budget preparation manuals” (Hughes 2003), prepared and left behind by dozens of consultants under different technical assistance and loan projects funded, from time to time, by various bilateral and multilateral agencies. However, due to lack of sustained capacity building efforts, often adversely affected by a large turnover of the key personnel in the ministries and departments, and other similar disruptions, manuals have gathered dust and remained unused. As a result, there have been frequent expenditure overruns, resulting in regular, supplementary budgets during the fiscal years. More stringent internal control systems by strengthening concurrent internal audit controls and timely reporting measures to the heads of departments are needed. Although Fiji has introduced

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9 The empirical results of a 29-country study by Gupta et al. (2004) on fiscal adjustment experiences show: (i) reallocation of recurrent expenditures to capital outlays is positively related to the persistence of fiscal adjustment; (ii) large levels of wages and salaries, transfers and subsidies increases the probability of ending a fiscal adjustment; (iii) for each one percentage point of GDP increase in cumulative fiscal adjustment, the probability of ending the fiscal consolidation episodes falls by 4 percent. (iv) the countries with larger cumulative reductions in the deficit are likely to abandon their adjustment efforts than others; (v) countries, which start the consolidation process with high budget deficits, are more likely to end it prematurely.
the system of enforcing accountability of the permanent secretaries of departments/ministries through surcharging the culprit bureaucrats, the intended penalties are rarely enforced. Despite the existence of public financial management programmes in terms of legislative and administrative regulations, the impacts are not significant, which are attributed to due to governance problems, (Browne 2006).

Past experiences as borne out in PNG, fiscal consolidation efforts undertaken for a continuous period of three to four years, until another election intervened, did record some notable achievements in reducing deficits. For three years in a row beginning from 2003, PNG ran an overall fiscal balance, meeting all domestic and external interest payment obligations. Significantly in 2006, a major policy initiative to reduce the number of departments either by abolishing or by merging, which would have been a major breakthrough in trimming operating expenditures to a considerable extent for a long time, was postponed to a later date after the 2007 general elections (ADB 2007).

Referring to Fiji’s experiences, D’Hoore (2006) notes that tightening of public expenditure had been achieved by cuts in wage and salary bill and if the tightening proved unpopular, it was normally reversed after some time. Since consolidation episodes in PICs are often short-lived, progress has not been sustained and fiscal adjustment efforts have been a failure without any lasting impacts, which is in accordance with the findings by Gupta et al. (2004).

Efficiency in Revenue collection

Revenue systems in PICs need overhauling. Aside from simplification of the tax system, the priorities should be given to a review of the current tax incentives for attracting investments in already flourishing industries such as tourism. Empirical evidence suggests that foreign investors are influenced by other factors; and tax factors are far from their main concern in deciding where to place their funds (Daniel et al. 2006).

Further, the questionable ministerial discretionary exemptions, which are mostly ad hoc, should be discontinued with. In the past, such ad hoc exemptions from customs and import duties along with personal income and corporate tax holidays for some specific investment activities were cases of suspected corruption, which were never investigated and culprits never punished. Proliferation of exemptions –both statutory and discretionary- undermines integrity and revenue raising potential (Browne 2006).

Countries, which are heavily dependent on import and export duties are aware of the revenue implications of introduction of free trade by 2010, first amongst PICs under the Pacific Island Countries Trade Agreement (PICTA), and later, ultimately with Australia and New Zealand under Pacific Agreement on Closer Economic Relations (PACER), which were signed in 2002. Kiribati, Samoa, Tonga, Tuvalu and Vanuatu, which are dependent on import duties, are likely to have the largest impact in terms of reduced tariff revenues. A study by Toatu et al. (2004) stressed the need for fiscal reforms to address the likely fall in their tax revenues. The recommended measures are: (i) conversion of selected import duties to excise taxes, which are WTO incompatible; and (ii) broadening
the tax system by introducing consumption based taxes, such as value-added taxes (VAT). Although about half the countries in the region have introduced VAT, an IMF study (Browne 2006) notes that VAT administration could be improved by faster processing of rebates, improved compliance at ports (where most revenue is collected) and upgraded capacity for conducting audits.

Vanuatu, in particular, has to review its tax system, which has been deliberately adopted to maintain its 30-year old pure tax haven status for attracting funds from overseas in lodging with the country’s offshore financial centre (OFC) institutions. The gains from OFC institutions are seen to be declining at the cost of revenue potential lost from the foregone opportunity to tax personal and corporate incomes. Vanuatu has to seriously consider introducing direct taxes so as to reduce the regressive nature of the current tax regime as well. Increase in revenue mobilisation contributes to strengthening fiscal consolidation efforts, which start initially with cutting current expenditures. Increases in revenue to GDP ratio lengthen the duration of fiscal consolidation, which is critical for long lasting impacts (Gupta et al. 2004).

**Measures responding to Volatility in Non-tax Revenue**

With regard to reducing the volatility in natural resource rent incomes for PICs, the recommendation by Toatu et al. (2004) is worth considering: revenues from fishing licenses and other resource rent incomes should also be deposited in trust funds such as RERF in Kiribati and TTF in Tuvalu. Presently a multiyear contract is negotiated with fishing nations that involve a fixed yearly payment over the term of the contract. Since there is an asymmetry of information about the likely catch and the likely price, the country owners of offshore fishing firms should be asked to bid against each other through an auction, which would force them to be more “truthful” about their likely catch. In exchange for a five year fishing contract, firms should be asked to bid a five yearly stream of payments, which would ensure maximum access fees as the present license fees are well below the “true resource rent” (Duncan and Temu 1997).

PICs with trust funds have to safeguard their trust funds by limiting the drawdowns for maintaining the per capita real value of assets. Although Kiribati’s parliament has mandated that the value of RERF be kept constant, there was no requirement of a prior approval of the parliament to drawdown from the trust fund. Appropriate legislative amendments in the country’s Public Finance Act may be considered for such parliamentary clearance.

**Re-directing Moneys into Capacity Building Investments**

Tackling the wage bill, reducing subsidies and discontinuance of transfers to non-viable state enterprises either by closures or divesting them to interested private sector parties, are durable expenditure reductions (Alesina and Prerotti 1995b). Since these adjustments would result in substantial annual savings, the resources so saved are available for reallocating into capital outlays for productive investments. Redirecting the funds so
saved from recurrent expenditures into capital outlays is positively related to persistence of fiscal adjustment as well (Gupta et al. 2004).

Samoa’s fiscal reform experiences are relevant here. Restructuring of civil service, which began in 2001 by downsizing the ministry of public works, was carried through until 2003. The programme was successful in reducing the number of ministries from 28 to 13. There were reductions in staffing numbers as well, through natural attrition and a freeze on funding for vacant positions, which brought down the public sector wage, well below that of comparator countries in the region (Leigh 2006), as overall budget deficit of 0.4 percent of GDP was recorded in 2006. The fiscal consolidation measures enabled Samoa to re-direct more funds for investment projects. Thus, the composition of public expenditure differed much from that of comparator countries, contributing to strengthening fiscal consolidation measures for longer lasting impacts.

*Debt Management*

Domestic borrowing for financing fiscal deficits on a large scale in PICs was mainly confined to Fiji and PNG. As noted earlier, total government debt in Fiji in 2006, including contingent liabilities was estimated at 60 percent of GDP and country’s external debt was around 11 percent of GDP. While Fiji’s debt rose during a five-year period (2001-2006) to a high figure in 2006, PNG’s government debt level decreased over the four-year period from 73 percent in 2002 to 42 percent of GDP in 2006. PNG’s external debt level also decreased over the period. It was 21 percent of GDP in 2006 (ADB 2007). The reductions in PNG’s debt levels were achieved mainly through fiscal consolidation efforts since 2001, in pursuance of a medium debt strategy. The latter provides for a gradual replacement of external debt by domestic debt and the restructuring of domestic debt from short-term treasury bills to long term government bonds.

Since PICs are eligible for borrowing from international funding agencies on concessional terms, their public debt was mainly external. Several PICs utilized the opportunity in the past to borrow from ADB and the World Bank for several capital projects. When the time arrived for meeting interest and installment obligations, PICs realized that they should have earmarked budgetary savings for servicing external debt. Both domestic and external debts require careful fiscal management. Additionally, growth in external debt is also subject to both interest rate and exchange rate risks. Since external debt servicing has to be effected in foreign exchange, PICs have to ensure adequate provision for foreign exchange.

There have been some cases of defaults in the past. Solomon Islands, which could not meet debt-servicing obligations on time in the 1990s, was subsequently rescued by bilateral donors. RMI failed in 2006 to meet the debt service requirements. Estimates of debt sustainability in RMI have determined the net present value debt to GDP ratio at around 80 percent and debt service as proportion of exports at 78 percent. An ADB study
(2007) has cautioned that even if no new external debt were incurred in 2007, debt service would increase over the next five years.

The only way out for RMI and other PICs under similar circumstances is to resort to fiscal consolidation in a sustained manner. Such fiscal consolidation measures have proved effective as shown by Samoa’s experiences. In the mid 1990s, Samoa’s external debt was more than 100 percent of GDP. Fiscal consolidation measures undertaken by Samoa in the late 1990s and carried through the next three years, contributed to gradual reduction in debt stock, which stood at 36 percent of GDP in 2006. A debt sustainability analysis undertaken by IMF in 2005 reveals that isolated shocks to the economy would not seriously affect the debt ratios but a combination of shocks, such as volatility in aid receipts and remittances and hikes in oil price, might raise the debt level (ADB 2007).

Vanuatu is the only country in the region, which has a restrictive legislative provision in regard to the level of external debt. The country’s parliament by an act defined the “prudent level” of external debt/GDP ratio at 40 percent and debt service/domestic revenue ratio at 8 percent. It is understood that a similar restrictive legislation was once contemplated in Fiji some time ago. PICs can consider emulating Vanuatu in adopting a similar restrictive legislative measure in containing debt levels, which would prove useful as guiding goals in debt management.

Maintenance of Competitive Real Exchange Rate

In the context of rising external debt level in some PICs, resulting in higher debt-servicing burden, growth in exports becomes critical. Since fiscal deficits give rise to inflationary pressures, which lead to increase in real exchange rates, the limited range of export commodities as well as tourism services become less competitive to the rest of the world. As PIC governments are recipients of substantial amounts of official transfers, there is always a possibility of diversion of the official transfer proceeds to financing the recurrent expenditures, either budgeted or unbudgeted. The latter would generally include additional higher adjustments in salaries, such as cost of living adjustments (COLA)\(^\text{10}\) and other government consumption of local goods and services, with adverse impact on prices of nontradables, unless adequate vigilance is exercised by budgetary intuitions. The so called “Dutch disease” would then set in pushing the real exchange rate further up, with disastrous effects on export earnings\(^\text{11}\).

\(^\text{10}\) Fiji’s fiscal deficit rose to 4.7 percent of GDP in 2006, due to the unanticipated cost of living adjustment (COLA) commitments to its salaried civil service employees. To meet this extra demand, F$ 58 million was re-deployed in August 2006 (RBF 2006a).

\(^\text{11}\) Two recent studies (Rajan and Subramanian (2005), Raghuram and Subramanian (2005) indicated that some of the aid receiving countries in Africa were under the influence of the “Dutch disease”, the effect of which, is reflected in the appreciation of real exchange rate. Appreciation of real exchange rates has been seen to adversely affect the competitiveness of exports, thereby weakening economic growth.
Those PICs, which resort to external borrowing with avowed purpose of financing deficits and in particular the capital projects, should also be aware of such a possibility of diversion of externally borrowed moneys for meeting unanticipated and unbudgeted planned new consumption expenditures\textsuperscript{12}. The risks of such possibilities are greater in times of political instability, unless the PICs concerned have strong and well established, budgetary control mechanisms in place. Maintenance of a competitive real exchange rate is a critical requirement for PICs, which resort to external borrowing to supplement domestic resources, since future debt-servicing obligations have to be met only through adequate export earnings.

4. Summary and Conclusions

This paper undertook a review of fiscal performance in PICs during recent years. Fiscal vulnerability indicators show that present debt levels, both domestic and external are presently not large enough to cause any immediate concerns. However, growing annual fiscal deficits experienced by some of them due to expansionary fiscal policies, if not reduced in time, would place them in high-risk situations.

With impending free trade by 2010 amongst PICs in the first instance under PICTA and later with Australia and New Zealand, PICs cannot depend on the current tax regimes, which are heavily dependent on trade taxes. Increased revenue mobilisation efforts have to be undertaken together with fiscal consolidation. The following areas need early attention: (i) effective expenditure control and budget–monitoring; (ii) efficient revenue system; (iii) improved measures for responding to frequently variable non-tax revenue receipts and volatile aid inflows; (iv) re-directing aid moneys into capacity building projects by trimming civil service and reducing recurrent expenditures; (v) careful debt-management; and (vi) improving foreign earnings from limited range of exports and services including tourism by maintaining a competitive real exchange rate so that external debt servicing does not pose problems in the long run.

Fiscal discipline is also conditioned by political factors, which include power sharing coalition arrangements. Such arrangements are likely to achieve inclusiveness only at the cost of fiscal discipline. Referring to transition economies, Fabrizio and Mody (2006) observed that more fragmented coalitions tended to be fiscally less conservative. In Fiji, governments in recent months dictated by coalition arrangements accommodated certain interests resulting in greater competition for limited fiscal resources. Special schemes were implemented for promoting certain interests. With poor control over expenditures and lack of supervision, several of them resulted in scams. The quality of budgetary institutions matters here, as in transition economies, since they would have a material bearing on fiscal discipline. As Fabrizio and Mody (2006) strike a cautionary note that

\textsuperscript{12} The international bond issue by Fiji in September 2006 for US$ 150 million is a case in point with the official announcement that the proceeds of the issue were expected “to be used to meet the Government’s 2007 budget deficit requirements, and in particular, to finance its capital projects” (RBF 2006c: 12).
the tussle between the forces supporting sound institutions and the politics of pressures on limited budgetary resources will continue.

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