
THE ROLE OF FISCAL POLICY IN RESILIENCE BUILDING: EXPERIENCES OF PACIFIC ISLAND COUNTRIES

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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 have faced adverse conditions during recent years such as fall in demand for primary commodities and services, including tourism. Furthermore, the 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 chapter reviews recent trends in fiscal performance and investigates problem areas of fiscal adjustment.

1. Introduction

In recent years small states have been facing adverse economic conditions, which have been hurting their economic growth and in some cases 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, which is the benchmark rate required to halve the incidence of poverty by 2015 (Dollar and Kraay, 2001; AusAID, 2005). External shocks including a 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 a higher than usual occurrences in recent years of natural disasters have all been cited as reasons behind the lacklustre economic performance of small island states in general and of PICs in particular.

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 the 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 have failed to quickly restructure their ailing export industries.

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.¹ 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 which 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 these twin deficits has been exercising considerable pressures on exchange rates. In these circumstances, fiscal adjustment measures are likely to be painful. Aside from slowing down their efforts toward the achievement of MDGs, expenditure cuts adversely affect critical issues such as health, education and the creation and maintenance of physical assets.

The objective of the chapter is to undertake a review of the fiscal performance in PICs and evaluate their progress towards achieving a higher degree of nurtured resilience. The chapter 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 in PICs; and the fourth and final section presents a summary.

2. Fiscal Trends in Pacific Island Countries

Among the 14 PICs (see Table 1 for the selected social and economic key indicators) which are members of the regional organisation known as the Pacific Forum, only one country, namely Papua New Guinea (PNG) has an independent, floating currency (see Table 2).

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 Economic and Social Indicators

	Population ('000) 2004	Area ('000) Km ²	Per Capita GDP US\$ 2004	HDI Rank 2003	Aid per Capita US\$ 2004	% of GDP 1990	% of GDP 2004
Cook Islands	19	0.2	2,651	62	490	NA	28.0
Fiji	841	18.3	2,720	92	76	3.9	2.6
Fed States of Micronesia	110	0.7	2,300	120	787	NA	36.0
Kiribati	98	0.7	970	129	171	22.5	17.8
Palau	20	0.5	6,870	NA	978	NA	15.0
Papua New Guinea	5,722	462.0	560	137	46	7.2	7.6
Republic of Marshall Is.	61	0.2	2,320	121	836	49.6	37.4
Samoa	184	2.8	1,840	74	167	42.6	8.2
Solomon Islands	468	28.9	560	128	262	21.7	47.8
Tonga	102	0.7	1,360	54	109	26.3	9.1
Tuvalu	11	0.003	345	118	260	47.2	45.0
Vanuatu	207	12.2	1,390	118	162	33.0	12.4

Source: Commonwealth Secretariat (2000; 2006)

Table 2
Pacific Island Countries

	Real GDP Growth Rate		Inflation	
	1995-2005 (%)	2001-2005 (%)	1995-2005 (%)	2001-2005 (%)
<i>A. Countries with no separate legal tender:</i>				
Cook Islands	3.0	4.3	2.7	2.9
Kiribati	3.0	-0.2	1.9	1.9
FSM	-	0.9	1.8	1.3
Palau	2.8	1.4	2.0	1.3
RMI	-0.6	3.0	3.2	1.3
Tuvalu	2.9	6.4	5.6	3.0
<i>B. Countries with currencies pegged to a basket of currencies:</i>				
Fiji	2.3	2.6	3.1	2.9
Samoa	4.1	4.2	3.8	5.3
Solomon Islands	-0.04	0.8	8.8	8.0
Tonga	2.2	2.1	6.0	10.2
Vanuatu	2.2	0.4	2.3	2.2
<i>C. Country with floating exchange rates:</i>				
PNG	1.1	1.7	10.7	8.1

Source: UNESCAP (2006) and author's calculations

Out of the remaining 13, eight PICs (Cook Islands, Federated States of Micronesia, Kiribati, Nauru, Niue, Palau, Republic of Marshall Islands, and 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 exchange rates pegged to a trade weighted composite basket of currencies of their major trading partners.

Dominance of Fiscal Policy

In the case of PICs, differences in exchange rate regimes did not have a significant impact on inflation levels (see Table 2). This is confirmed by Rosales (2001). 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.

It is well known that under fixed exchange rate regimes, the role of monetary policy is less effective. In the past, the 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 the near total dismantling of exchange controls especially in regard to the current account, monetary policy is not likely to play any effective role. Furthermore, within the context of the nascent money and capital markets in all PICs, the transmission mechanism of monetary policy has been found to be weak. A recent study on the effectiveness of fiscal and monetary policies on Fiji's economic growth covering the period 1970-2002² found an 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, the economic growth of Fiji was positively influenced only by fiscal policy (Dahalan and Jayaraman, 2006).

It appears that fiscal policy has been the foremost policy tool for PICs.³ What is striking is that overall fiscal balances⁴ of all PICs, with the

² The study, which covered the period 1970-2002 employed real government expenditure and real net foreign assets respectively representing fiscal policy and monetary policy.

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 private sector investment; (iii) government revenues rise as a proportion of GDP with a rise in per-capita income; and (iv) a rise in income is associated with a fall in the share of the international trade taxes in total government revenues.

⁴ This paper uses the overall balance (total government revenue including grants minus total expenditure including interest payments) rather than the primary balance (same as the overall balance but excluding interest payments). (continued next page)

exception of the Republic of the Marshall Islands (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 US⁵, have been negative (see Table 3, next page).

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 (see Appendix 1). The shares of non-tax 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 non-tax 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 the Marshall Islands 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

⁴ (Continued from previous page) The Primary balance which would have been more appropriate as it reflects the country's fiscal effort (Daniel et al., 2006) to generate surpluses (Sahay, 2004), and this is a critical variable for debt sustainability analysis. However data on interest payments are not available on a time series basis for all PICs.

⁵ The Republic of the Marshall Islands (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.

Table 3
PICs: Government Revenue, Expenditure and Overall Balance

	Govt. Revenue % of GDP		Govt Expend. as % of GDP		Overall Balance as % of GDP	
	Average	Std Dev	Average	Std Dev	Average	Std Dev
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
Solomon 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
RMI	74.2	4.6	67.6	18.6	6.6	15.9
Samoa	31.8	7.4	47.2	17.8	-15.4	9.2
Solomon Is	20.9	4.3	35.7	5.3	-14.8	8.6
Tonga	28.2	1.1	29.3	1.5	-1.1	1.6
Vanuatu	20.3	0.9	23.9	2.9	-3.6	2.4
2000-2005						
Fiji	25.3	0.9	30.3	1.1	-5.0	1.1
FSM	63.5	9.1	65.0	8.1	-1.5	7.1
Kiribati	120.7	16.5	140.2	22.9	-19.5	16.5
PNG	26.4	6.4	30.4	2.5	-4.0	1.9
RMI	64.3	9.9	61.2	5.4	3.1	6.5
Samoa	33.0	1.1	34.9	5.7	-1.9	0.8
Solomon Is	28.2	4.4	30.6	2.9	-2.4	4.5
Tonga	30.5	2.7	32.3	3.2	-1.8	4.4
Vanuatu	23.4	2.1	30.4	6.8	-7.0	2.9

Source: Author's Calculations and Asian Development Bank (2006)

provider of services. Table 3 presents government expenditures as proportion of GDP for selected PICs. The high ratios in PICs such as Kiribati (123 percent), Federated States of Micronesia (74 percent), and the Republic of the Marshall Islands (84 percent) during 1988-2005 reflect the situation that PICs with small populations 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 the Marshall Islands and the Federated States of Micronesia mainly financed government consumption and high government wages. This was not in line with the primary objective of Compact, which was to enable the recipient countries to reach self-sufficiency and self-reliance.

Although reforms have begun in the late 1990s with a view to trimming the civil service, the 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

Appendix 1, which presents some of the fiscal vulnerability indicators⁶, shows that overall fiscal balances have been negative for all countries, except the Marshall Islands which, as noted earlier, has been receiving substantial aid under the Compact I and II. The highest average negative overall balance during the 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 a substantial drawdown from the Revenue Equalisation Reserve Fund (RERF)⁷ and in Tuvalu by similar recourse to the Tuvalu Trust Fund (TTF), Fiji's fiscal deficits were financed entirely by domestic

⁶ The International Monetary Fund, which conducts periodical surveys of economic and financial conditions of its member countries, as part of Article IV consultations, has developed certain indicators to assess fiscal performance. These indicators generally include annual overall budget balance as percentage of GDP, current account in the balance of payments, as a percentage of GDP, international reserves for countries under fixed exchange rate regimes as equivalent to certain number of months of imports, outstanding foreign debt stock as a percentage of GDP and annual debt servicing expenditure as a percent of total earnings from exports of goods and services. The indicators facilitate assessment of economic health of the economy. There is no sanctity attached to any number. The desirable indicators, such as 3 percent of GDP for overall fiscal balance, six month-imports equivalent as international reserves as requirement or a limit of 50 percent of GDP as the total debt of a country are just reminders to governments. If an indicator is above the general acceptable level, it should cause concern to policymakers as well as to international funding agencies which are interested in the recovery of loans extended to member countries.

⁷ The RERF was set up in 1956, for receiving and holding royalties collected from phosphate mining companies. Its funds were invested in overseas securities. (continued next page)

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.

In the past two decades, central bank financing of fiscal deficits was not uncommon. Deficits in PNG, Solomon Islands, and Vanuatu were financed through borrowing from the central bank. For example, PNG's large budget deficits of the mid-1990s, which were incurred due to defence spending, tax reductions, agricultural subsidies, and persistent expenditure overruns, were monetised by its central bank. Central bank autonomy was established by a much needed legislation only much later in 2000 (Marciniak, 2006). In Vanuatu, the unsubscribed 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 a greater appreciation of the need for administrative measures to promote fiscal and monetary policies coordination (Ali and Jayaraman, 2001) in the latter 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 the Asian Development Bank and the World Bank. However, those PICs which were 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.

⁷ (Continued from previous page) In 1996, parliament laid down that value of RERF per capita should be kept constant for future generations. The market value of RERF rose from A\$ 97.1 million in 1984 to A\$666 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, reaching 25 percent of GDP (Feyzioglu, 2006).

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,⁸ 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.

Fiscal deficits either funded by continuous borrowing or by drawing down funds leads to a rise in aggregate demand, which eventually spills over into demand for foreign goods and services. Were it not for substantial aid inflows and remittances, the current account balances in several PICs would have become negative. Since Fiji is not a major recipient of aid (Table 1), current account deficits became chronic and increasing during 2001-2005, despite a surge in remittances since 2003. Table 4 presents data relating to budget, trade and current account balances for selected PICs.

Table 4
Budget, Trade and Current Account Balances of Selected Countries
 (Averages as % of GDP)

	Budget Balance			Trade Balance			Cur. Acct Balance		
	1990-94	1995-99	2000-04	1990-94	1995-99	2000-04	1990-94	1995-99	2000-04
Fiji	-3.2	-3.2	-5.1	-14.4	-11.6	-17.0	-2.1	-0.2	-7.0
PNG	-3.7	-0.8	-1.5	+14.7	+21.0	+26.5	+3.8	+4.6	+4.3
Samoa	-10.5	-0.2	-1.3	-68.3	-38.7	-41.4	-13.2	+5.0	-0.2
Solomon Is	-6.1	-0.9	-5.8	-0.9	+2.1	-1.1	-6.6	+1.1	+1.4
Tonga	0.0	-1.1	-1.1	-30.0	+2.1	-35.1	+1.5	-6.7	-2.2
Vanuatu	-4.6	-3.2	-2.7	-30.3	-20.2	-23.8	-7.2	-8.8	-4.6

Source: Asian Development Bank (2006) and author's calculations

⁸ Fiji's credit rating had, however, fallen since December 2006, due to a military coup and continuing distrust in the interim government by the international community. In late 2006, 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 (Reserve Bank of Fiji, 2006b).

With the exception of PNG, which ran trade surpluses 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; Normandin, 1999), two recent studies in regard to PICs (Jayaraman and Choong 2007; 2008) 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).

As Fiji's international reserves were declining since 2002, pressures were mounting on the exchange rate, leading to speculative attacks during the second half of 2006, as rumours were rife about an 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, 2006b). Fiji's monetary authority, the Reserve Bank of Fiji (RBF) imposed exchange controls on capital transactions in December 2006 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 one 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. 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 rate regime, which delivered a measure of external stability, though only for a short period. A sharp contraction in exports due to drought in 1997 and the 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, fiscal excesses were again indulged in by the incumbent government to recapture power, which led to the deterioration of both budget and current account balances. After three years of negative growth, PNG's economy picked up in 2005, aided by sensible policies and an export boom. PNG's international reserves position improved and reached record levels, at higher than 5 months import cover.

The case of Solomon Islands is similar to that of PNG. The country experienced three decades of fiscal imbalances since becoming independent in 1978. The reasons were stagnant revenues, often eroded by tax and customs exemptions and a rise in current expenditures due to increases in wages and salaries, transfers to local governments and inadequate expenditure controls. There was a recovery in the external current account during the first half of the 1990s primarily due to unprecedented logging and timber exports, which was however only short-lived. The ethnic conflict of 1999 and its aftermath resulted in negative growth for the next three years. The fiscal deficit reached a high of 12 percent of GDP in 2001, consequent to a decline in exports induced by the Asian financial crisis and civil strife. The international reserves position fell to its weakest-ever level (2 months of import cover) in the same year. 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.

In general, PICs continue to grapple with grave issues of macroeconomic instability since the beginning of the new Millennium due to expansionary fiscal policies. Stagnation in government revenues, lower 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 stresses on the servicing of foreign debt and on exchange rates. In these circumstances, the only feasible solution appears to be a programme of fiscal adjustment carried out in a sustained manner over the medium term. Although such efforts were initiated earlier in several PICs, they were often disrupted by the effects 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. Giving a broader definition, Daniel et al. (2006) clarify that fiscal adjustment would mean a change in fiscal stance, either tightening or loosening, as the situation would warrant. The term fiscal consolidation, with reference to twin deficits, implies reducing government deficit and debt accumulation.

Fiscal Consolidation

Reducing government spending as a remedy to reduce annual fiscal imbalances and accumulation of debt is not 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) expansionary fiscal spending through heavy public (Jayaraman and Choong, 2007). The fiscal consolidation measures which were indicated in the interim government's revised budget for 2007 included a reduction in the operating expenditures through the trimming of the number of ministries and departments from 36 to 16, cuts in wages and salaries of civil servants by 5 percent across the board and downsizing the size of the civil service through lowering the retirement age from 60 to 55 and freezing vacant positions. The 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 slowdown.

Experiences in Industrial Countries

Such fears were no doubt genuine, as fiscal consolidation 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 effects 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; Alesina and Perotti, 1995a) argue that sustained fiscal adjustment in terms of budget and debt reduction would result in lower interest rates, depreciating exchange rates "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 a fall in interest rates; and (iii) this will be followed by a reduction in default risk premium interest rates, as budgetary consolidation would improve the image of government in terms of its solvency. It is further argued that a reduction of public expenditure especially through lower public salaries and wages would have an impact on the cost of labour in the private sector, engendering profitability and competitiveness (IMF, 2001; Alesina et al., 1998). Fiscal consolidation driven by lower expenditure would send out signals to households and businesses that future tax burdens would be lowered, thereby resulting in crowding-in effects on private sector demand.⁹

There are no studies on the impact of fiscal adjustment in PICs comparable to McDermott and Westcott (1996a). 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) taking into account fiscal adjustment episodes in 29 developing countries in different regions under IMF-supported programmes in the 1990s shows that the success of fiscal adjustment, in terms of the persistence over time of its positive effects, is (i) positively determined by factors which include the reallocation of recurrent expenditures to productive capital projects; and (ii) negatively influenced by large outlays on wages and salaries.

Fiscal adjustment measures include: (i) strengthening expenditure control and budget-monitoring; (ii) enhancing the efficiency of revenue systems; (iii) introducing measures to offset the volatility in revenues generated by non-tax revenue receipts and aid inflows; (iv) redirecting aid resources into capacity building investments by streamlining the civil service and reducing recurrent expenditures; (v) enhancing debt-management practices; and (vi) improving foreign exchange earnings and maintaining a competitive real exchange rate so that external debt servicing does not pose undue problems in the long run.

⁹ While noting that the non-Keynesian effects were important in those euro area countries characterised by high levels of government debt and large public sectors, IMF studies (1996, 2001) observed that the impact of reduced fiscal spending on output in the short term is an area of some dispute.

Effective Expenditure Control

Since revenue mobilisation in PICs is seriously constrained by structural rigidities, such as narrow revenue bases with heavy dependence on international trade taxes, fiscal consolidation efforts would necessarily have to be based 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, in spite of the prevalence of ghost-employees and high rates of absenteeism. Although it is being increasingly realised that a leaner civil service with adequate remuneration and incentives could be more efficient and productive, the ongoing efforts towards this aim are in general half-hearted, as they often involve redeployment of personnel within the public sector itself with little, if any, efficiency gains..

Budgetary exercises are often hampered by unrealistic forward estimates, typically involving underestimates in relation to operating expenditure and overestimates for new capital projects. The PICs are "littered literally with budget preparation manuals" (Hughes, 2003), prepared by consultants under various technical assistance and loan projects initiatives. However, due to lack of sustained capacity, which is often adversely affected by a large turnover of the key personnel in the ministries and departments, appropriate budgetary procedures are often not used. As a result, there have been frequent expenditure overruns. More stringent internal control systems by strengthening concurrent internal audit controls and timely reporting measures to the heads of departments are needed. Fiji has introduced the system of enforcing accountability of the permanent secretaries of departments/ministries through surcharging the culprit bureaucrats, but the statutory penalties are rarely enforced. Governance problems hinder the implementation of effective public financial management programmes (Browne, 2006).

In PNG, a series of fiscal consolidation efforts undertaken for continuous periods of three to four years, albeit influenced by political business cycles, 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. However a major policy initiative to reduce the number of departments, which would have considerably trimmed recurrent expenditures proposed in 2006 was postponed to a later date after the 2007 general elections (ADB, 2007).

Referring to Fiji's experiences, D'Hoore (2006) notes that a tightening of public expenditure had been achieved by cuts in the wage and salary

bill. The tightening proved unpopular at first, but this was 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 the simplification of tax systems, priority should be given to a review of the current tax incentives for attracting investments in already flourishing industries such as tourism. This in view of the fact that empirical evidence suggests that decisions of foreign investors are influenced primarily by factors other than tax considerations (Daniel *et al.*, 2006). This however requires an emphasis on the nurturing of competitiveness within PIC economies. Further, the questionable ministerial discretionary exemptions, which are mostly ad hoc, often exercised in PICs should be discontinued with. In the past, such ad hoc exemptions from custom and import duties along with personal income and corporate tax holidays for some specific investment activities may have involved elements of corruption. The 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 the introduction of free trade by 2010, first amongst PICs under the Pacific Island Countries Trade Agreement (PICTA), and later with Australia and New Zealand under Pacific Agreement on Closer Economic Relations (PACER). Kiribati, Samoa, Tonga, Tuvalu and Vanuatu, which are dependent on import duties, are likely to suffer 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 an upgraded capacity for conducting audits.

Vanuatu, in particular, needs a review of its tax system, which has been for 30 years geared towards maintaining a tax haven status to attract overseas funds into the country's offshore financial centre (OFC) institutions. The gains from OFC institutions are obtained at the cost of

revenue 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.

Measures to Counteract 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 be deposited in trust funds such as Kiribati Revenue Equalisation Reserve Fund (RERF) and the Tuvalu Trust Fund (TTF). Presently a multi-year 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 offering a five-yearly stream of payments, which would ensure maximum access fees. It is likely that the present license fees are well below the “true resource rent” (Duncan and Temu, 1997).

PICs have to safeguard the real per capita value of their trust funds by limiting the draw-downs. Although Kiribati’s parliament has mandated that the value of RERF is to be kept constant, there was no requirement of a prior approval of the Parliament to draw down 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 discontinuing transfers to non-viable state enterprises are effective ways to ensure durable expenditure reductions (Alesina et al., 1995b). Since these adjustments would result in substantial annual savings, the resources saved would be available for reallocation to capital outlays for productive investments. This is also consistent with the persistence of the benefits of fiscal adjustment (Gupta et al., 2004).

Samoa’s fiscal reform experiences are relevant in this regard. The restructuring of the civil service which began in 2001 was carried through until 2003. The programme reduced 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 bill well below that of comparable countries in the region (Leigh, 2006). The fiscal consolidation measures enabled

Samoa to redirect more funds for investment projects. This contributed 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 the country's external debt was around 11 percent of GDP. While Fiji's debt rose during the 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. The latter reductions were achieved mainly through fiscal consolidation efforts since 2001, within a medium-term debt strategy aimed at 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 utilised the opportunity in the past to borrow from the Asian Development Bank (ADB) and the World Bank to finance capital projects. When the time arrived for meeting interest and instalment obligations, PICs realised 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 an adequate provision for foreign currency for the purpose.

There have been some cases of default in the past. Solomon Islands, which could not meet debt-servicing obligations on time in the 1990s, was subsequently rescued by bilateral donors. The Marshall Islands also failed in 2006 to meet debt servicing requirements. Estimates of debt sustainability in the Marshall Islands 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, the burden of its servicing would increase over the next five years.

The only way out for the Marshall Islands and other PICs under similar circumstances is to resort to fiscal consolidation in a sustained manner. Such fiscal consolidation measures can be 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 a

gradual reduction in debt stock, which stood at 36 percent of GDP in 2006. A debt sustainability analysis undertaken by the IMF in 2005 revealed 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 to GDP ratio at 40 percent and debt service to 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 could prove to be useful guidelines in debt management.

Maintenance of a Competitive Real Exchange Rate

In the context of rising external debt levels in some PICs resulting in higher debt-servicing burdens, growth in exports becomes critical. Since fiscal deficits give rise to inflationary pressures, which lead to increases 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 such proceeds to finance recurrent expenditures. The latter would generally include upward adjustments in salaries¹⁰ and other government consumption of local goods and services, with adverse impact on prices of nontradables. The so-called "Dutch disease" would then set in pushing the real exchange rate further up, with disastrous effects on export earnings.¹¹

Those PICs which resort to external borrowing for the purpose of financing deficits and in particular 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.¹² The risks of such possibilities are greater in times of political instability, unless the PICs concerned have strong and well

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 (RBF, 2006a).

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 rates. Appreciation of real exchange rates has been seen to adversely affect the competitiveness of exports, thereby weakening economic growth.

¹² Fiji's international bond issue in September 2006 of 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).

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

With impending free trade by 2010 amongst PICs, the current tax regimes which are heavily dependent on trade taxes will not be sustainable. This calls for revenue mobilisation efforts together with fiscal consolidation. The following areas need early attention: (i) the introduction of effective expenditure control and budget-monitoring systems; (ii) efficient and effective mechanisms for generating revenue; (iii) improved measures for responding to volatile non-tax and aid revenues; (iv) redirecting fiscal resources into capacity building projects by trimming the civil service and reducing recurrent expenditures; (v) careful debt management; and (vi) improving foreign earnings so as to be able to service external debt.

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Appendix 1
Fiscal Vulnerability Indicators of Selected Countries
(Percentage of GDP unless otherwise stated)

	2001	2002	2003	2004	2005
Fiji					
Revenue & Grants	22.1	24.6	25.1	25.8	25.8
Expenditure & Net Lending	28.6	31.6	31.1	29.1	29.6
Overall Balance	-6.5	-7.0	-6.0	-3.3	-3.8
Government Debt	44.0	48.0	49.0	53.0	52.0
External Debt	13.6	13.7	12.2	10.9	11.1
Current Account Balance	-3.5	-1.7	-2.0	-5.0	-4.5
Intl.Reserves (months of imports)	4.3	3.5	3.1	3.3	3.5
Exch Rate (against US\$)	2.3	2.2	1.9	1.7	1.7
Kiribati					
Revenue & Grants	118.4	138.7	139.2	106.2	123.2
Expenditure & Net Lending	135.4	139.3	171.0	149.0	145.8
Overall Balance	17.0	0.6	-31.9	42.8	-22.6
External Debt	20.0	16.4	16.0	17.5	19.0
Current Account Balance	2.0	-1.8	-19.3	-16.3	-9.4
Intl.Reserves (months of imports)	NA	NA	NA	NA	NA
Exch Rate (against US\$)	1.9	1.8	1.5	1.4	1.3
Marshall Islands					
Revenue & Grants	70.1	64.2	65.0	56.2	58.1
Expenditure & Net Lending	61.9	68.2	54.0	56.6	60.2
Overall Balance	8.2	-4.0	11.0	-0.4	-2.1
External Debt	77.0	70.6	71.2	76.4	70.6
Current Account Balance	8.8	8.6	16.3	4.4	0.5
Intl.Reserves (months of imports)	NA	NA	NA	NA	NA
Exch Rate (against US\$)	1.0	1.0	1.0	1.0	1.0
Micronesia (Federated States of)					
Revenue & Grants	64.2	71.8	71.8	53.7	51.0
Expenditure & Net Lending	73.1	65.0	63.8	58.6	54.2
Overall Balance	-8.9	6.8	7.9	-4.8	-3.2
External Debt	26.3	25.6	25.2	25.8	24.8
Current Account Balance	-5.4	7.3	0.9	-10.6	-12.1
Intl.Reserves (months of imports)	NA	NA	NA	NA	NA
Exch Rate (against US\$)	1.0	1.0	1.0	1.0	1.0
Palau					
Revenue & Grants	43.1	42.4	54.0	54.3	53.6
Expenditure & Net Lending	64.6	66.3	62.6	61.7	54.2
Overall Balance	-20.3	-28.3	-2.4	-6.9	-3.9
External Debt	16.2	16.6	15.9	14.0	13.2
Current Account Balance	-9.4	-11.0	9.6	12.6	15.1
Intl.Reserves (months of imports)	NA	NA	NA	NA	NA
Exch Rate (against US\$)	1.0	1.0	1.0	1.0	1.0

Sources: Asian Development Bank (2006), IMF (2006) and author's calculations

Continued next page.

Appendix 1 (continued)
Fiscal Vulnerability Indicators of Selected Countries
(Percentage of GDP unless otherwise stated)

	2001	2002	2003	2004	2005
Papua New Guinea					
Revenue & Grants	29.7	27.8	28.2	31.1	28.1
Expenditure & Net Lending	33.2	31.8	29.4	29.6	26.2
Overall Balance	-3.9	-5.3	-1.6	1.1	1.9
Government Debt	62.0	73.0	70.0	57.0	51.0
External Debt	48.7	51.5	43.8	34.3	27.7
Current Account Balance	6.5	-1.0	4.4	2.1	4.0
Intl.Reserves (months of imports)	5.7	4.5	5.6	5.8	5.1
Exchange Rate (against US\$)	3.4	3.9	3.5	3.2	3.1
Samoa					
Revenue & Grants	31.9	33.8	32.8	32.5	40.0
Expenditure & Net Lending	34.3	35.9	33.4	33.4	40.6
Overall Balance	-2.3	-2.1	-0.6	-0.9	-0.6
Domestic Debt	61.0	59.0	53.0	50.0	48.0
External Debt	61.4	62.0	59.6	51.5	48.1
Current Account Balance	0.1	-0.6	2.9	4.4	2.2
Intl.Reserves (months of imports)	3.6	4.2	3.4	3.5	3.9
Exch Rate (against US\$)	3.4	3.5	3.2	2.9	2.7
Solomon Islands					
Revenue & Grants	23.5	18.8	37.6	48.9	48.5
Expenditure & Net Lending	36.2	29.8	39.5	40.6	49.0
Overall Balance	-12.7	-11.0	-1.9	8.3	-0.5
Government Debt	82.0	97.0	99.0	87.0	78.0
External Debt	49.0	67.0	70.6	62.0	61.4
Current Account Balance	-12.8	-7.2	1.3	12.5	-10.8
Intl.Reserves (months of imports)	2.8	2.1	3.6	5.7	4.7
Exch Rate (against US\$)	5.6	7.5	7.5	7.5	7.5
Tonga					
Revenue & Grants	27.5	29.9	27.3	27.5	26
Expenditure & Net Lending	29	31.3	30.4	26.2	25.8
Overall Balance	-1.5	-1.5	-3.1	1.3	0.1
Domestic Debt	68	72	68	62	53
External Debt	40.4	46.3	43.9	40.9	35.6
Current Account Balance	-9.2	4.9	-3	4	-2.2
Intl.Reserves (months of imports)	1.8	2.8	2	4.8	4
Exch Rate (against US\$)	1.97	2.18	2.19	2.04	1.94
Vanuatu					
Revenue & Grants	20.9	21	20.1	21.9	22.3
Expenditure & Net Lending	24.6	25	21.8	21	21.2
Overall Balance	-3.7	-4.1	-1.7	0.9	1
Public Sector Debt					
Domestic Debt	38	41	41	38	37
External Debt	29.7	28.2	26.1	24.6	23.4
Current Account Balance	2	-9	-10.2	-9.5	-7.1
Intl.Reserves (months of imports)	3.1	5.2	4.3	4.3	4.8
Exch Rate (against US\$)	145.3	139.1	122.2	111.9	109.05