

## **7- Public Finance and National Debt as Constraints to Economic Growth**

**Prepared by Pacific Islands Forum Secretariat**

### **SUMMARY**

Government Finances play a key role in the mobilisation of scarce resources in the Forum Island Countries (FICs) for their development. Appropriate management of government finances and public debt is critical in building capacity of FICs' ability to respond to the inherent idiosyncratic vulnerabilities and emerging challenges emanating from the global economy, including their capacity to develop and implement sustainable national development plans. Forum Economic Ministers have made a commitment to provide regional oversight on appropriate reforms to deal with the above issues.

### **KEY ISSUES**

- Economic growth in the Pacific region has been comparatively low, narrow based and has also experienced high volatility.
- Some countries are in a weak situation with regard to debt, with unsustainable borrowing practices being used to prop up inefficient government enterprises.
- Heavy indebtedness is a problem for any nation large or small as it hinders economic growth and development. A high level of public debt weakens the government's ability to achieve its financial stability targets and affects macroeconomic stability.
- One feature of the Pacific region is that the economies are relatively small, however, the debt to GDP ratios are high, with the exception of a few economies.
- Heavy fiscal burden coupled with limited access to external finance means that the government would have little fiscal space to increase expenditures in public investment and social spending.
- If public debt finances are channelled into productive uses such as investments necessary for growth, including investments in infrastructure and education, then in the long run such debts may be justified as they will improve economic growth enabling debt repayment.
- Forum Economic Ministers have recognised that while the region faces natural constraints to growth, there are also issues in the areas of governance, macroeconomic management and public sector efficiency that Governments need to address to improve their growth prospects.
- At the 2012 Forum Economic Ministers Meeting (FEMM), Economic Ministers noted that their earlier calls for possible mitigation measures, which include, consolidating fiscal positions and creating precautionary fiscal space, easing monetary policy, and reinvigorating structural reform all remain sound options for dealing with global economic risks.

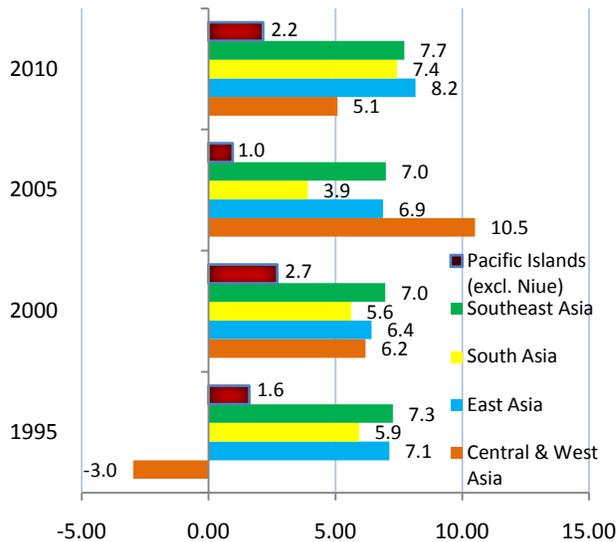
- Economic Ministers have noted the importance of Public Finance Management through endorsing and implementing the Public Finance Management Roadmap and acknowledged the need for ongoing information sharing of country experiences and lessons.
- A concerted and ongoing effort is needed to assist the FICs in effective and transparent management of their financial resources.

**BACKGROUND**

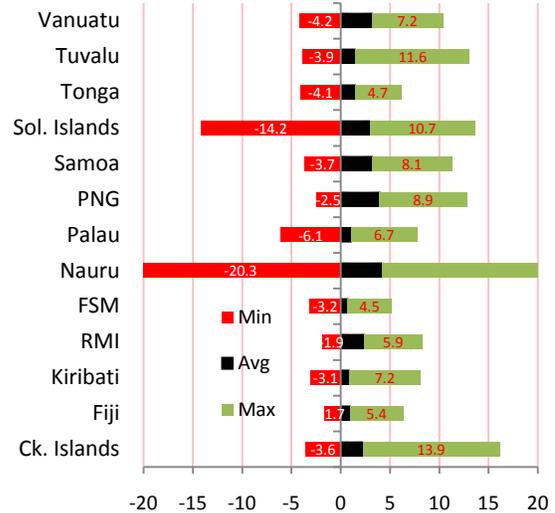
The Pacific region has experienced low economic growth and high volatility in the last few decades. The remoteness and geographic isolation of the majority of FICs has made it difficult to develop economically, one of the key underlying reasons for the least developed status of many countries in the region. Other key constraints, such as vulnerability to natural disasters, susceptibility to adverse global economic conditions<sup>1</sup>, narrow production base, low levels of productivity, and limited export variety exacerbate the challenges FICs face.

High variability in the major income sources (export revenues, remittances and tourism receipts), underdeveloped financial markets, reliance on foreign aid and high cost of doing business (such as, high transportation costs and reliability of certain crucial services) has contributed to lower than potential economic growth and considerable fluctuations in economic output from year to year (See Figure 1 and 2 on FICs Regional Growth Rates and National Variance in Growth Rates).

**Figure 1: Average Regional Real GDP Growth (%)**



**Figure 2: Variance in Real GDP Growth (%) 2000-2011**



Source: ADB

<sup>1</sup> Pacific countries are heavily exposed to commodity price fluctuations and are, therefore, very vulnerable to food insecurity and the impacts of a volatile international food and energy market.

Many FICs have suffered from problems of weak economic governance, which has limited the enabling environment for the private sector. Governments are also typically heavily involved in the economy which has led to inefficiencies in many cases. Some countries are in a weak and fiscally constraint position with regard to debt, with unsustainable borrowing practices being used to prop up inefficient government enterprises (ADB 2011). The FICs also face severe capacity constraints.

One feature of the Pacific region is that while most countries have relatively small open economies, the majority have high debt to GDP ratios (see Table 1 below). Of the two types of debt, external debt dominates total public debt. Given the heavy reliance of our island nations on the external sector (for example, tourism, trade and remittances) external debt sustainability is highly vulnerable to external shocks (UNDP 2010).

Heavy indebtedness is a problem for any nation large or small, as it hinders economic growth and development. A high level of public debt weakens the government's ability to achieve its financial stability targets and affects macroeconomic stability. Increase in public debt implies higher debt servicing in the future, which suggests that funds could be allocated away from important development targets. Focusing debt on current expenditure of the public sector may induce a cycle of indebtedness, and if a country has weak policies and institutions, repayment may become a problem even at low debt levels (IMF, 2012). The possibility of debt defaults may also affect a country's capacity to borrow further, possibly deterring potential investments. However, if public debt finances are channelled into productive uses such as investments necessary for growth, including investments in infrastructure and education, then in the long run such debts may be justified as they will improve economic growth, enabling debt repayment.

**Table 1: Debt Levels of Selected FICs**

Country	Total Public Debt (% GDP)	Year
Federated States of Micronesia	28.1*	2011
Fiji	54.2	2011
Kiribati	30	2009
Palau	35*	2006
Papua New Guinea	25	2011
Republic of the Marshall Islands	67.4*	2011
Samoa	49.3	2011
Solomon Islands	22	2011
Tonga	42.5	2012
Tuvalu	14.5	2011
Vanuatu	20	2011

\*External Debt

Source: IMF Article IV Country Reports, IMF Debt Sustainability Analysis Reports.

Forum Economic Ministers have recognised that while the region faces natural constraints to growth, there are also issues in the areas of governance, macroeconomic management and public sector efficiency that Governments need to address to improve their growth prospects. The recent global economic crisis impacted FICs, lowering income for both households and national governments, both leading to lower economic growth rates across FICs.

At the 2012 FEMM, Economic Ministers noted that their earlier calls for possible mitigation measures, which include, consolidating fiscal positions and creating precautionary fiscal space, easing monetary policy, and reinvigorating structural reform all remain sound options for dealing with global economic risks (FEMM 2012). They recognised the importance of strengthening public financial management, the development of the private sector and job creation in harmonisation with the principles of green economy, and broadening of the economic base as critical stepping stones to growth and development of the FICs (FEMM 2012).

Economic Ministers have noted the importance of Public Finance Management through endorsing and implementing the Public Finance Management (PFM) Roadmap. At the 2010 Forum Economic Ministers' Meeting, Ministers:

- Considered the need for periodic assessments of the PFM system, to allow progress against reform objectives to be tracked and priorities to be reassessed;
- Noted that assessment could be strengthened by establishing a central point for supporting the Public Expenditure and Financial Accountability (PEFA) assessment process in the Pacific, and in this regard, agreed that such a resource be based in the Pacific Financial Technical Assistance Centre (PFTAC);
- Noted that the regional resource would build and disseminate good practice in Pacific PEFA assessments, and coordinate and help execute assessments;
- Noted the progress reports that PFM reform process generates, which should form the core of development partner and national level monitoring, and that these reports could be presented and discussed amongst peers at the FEMM and annual meetings of the Pacific Islands Financial Managers' Association (PIFMA);
- Approved the Roadmap for strengthening public financial management for application as part of the tools for implementing the Forum Compact on Strengthening Development Coordination in the Pacific (Forum Compact) (FEMM 2010).

At the 2011 FEMM, Ministers agreed to provide regional oversight on reforms envisaged under the Roadmap for Strengthening Public Financial Management, and acknowledged the need for ongoing information sharing of country experiences and lessons (FEMM 2011).

There is ongoing engagement of the Forum Economic Ministers and various international, regional and national technical agencies to assist the FICs in addressing the issues relating to Public Finance and National Debt as a constraint to growth.



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