

2013 SMALL STATES FORUM
FISCAL SUSTAINABILITY: BUILDING RESILIENCE AND ADDRESSING VULNERABILITY

ISSUES NOTE

SESSION I:

economies. According to the IMF, 83 countries now have at least one fiscal rule in place. However, only few of them are small states.

Country	Type of fiscal rule in place				National, SupraNational			
	Expenditure rule	Revenue rule	Budget balance rule	Debt rule	Expenditure rule	Revenue rule	Budget balance rule	Debt rule
Antigua and Barbuda; Dominica; Grenada; St. Kitts and Nevis; St Lucia; St. Vincent and the Grenadines			1998-2005	1998-			SupraN	SupraN
Botswana	2003-				Nat			
Cape Verde			1998-	1998-			Nat	Nat
Cyprus; Malta			2004-	2004-			SupraN	SupraN
Equatorial Guinea			2002-	2002-			SupraN	SupraN
Estonia			1993-	2004-			Nat/SupraN	SupraN
Gabon			2002-	2002-			SupraN	SupraN
Guinea Bissau			2000-	2000-			SupraN	SupraN
Iceland	2004-2008				Nat			
Mauritius			2008-					Nat
Namibia	2010			2001-	Nat			Nat

Source: IMF, Fiscal Rules Dataset, 1985-2012

Although it is difficult to measure the impact of fiscal rules on fiscal outcomes, a growing body of empirical analyses concludes that they are associated with lower deficit and debt levels. Fiscal rules can help increase the predictability and credibility of fiscal policy, two outcomes that could be of particular appeal to small states.

Fiscal rules can also raise challenges for fiscal policy design, some of which are particularly relevant for small states:

Fiscal rules may lead to a pro-cyclical fiscal stance. A strict budget target, for example, may require sharp spending cuts or tax increases in a downturn, thereby aggravating the slowdown in demand. This is a particular concern for small states as the options to support demand through other means are often limited.

With a focus on fiscal aggregates rather than on their composition, the quality of fiscal policy may suffer. More specifically, efforts to contain the fiscal deficit may respond to expediency rather than efficiency reasons. For example, the authorities may choose to raise the taxes that yield quick results (e.g., excise taxes) even if these are not the most efficient for the economy. This may lead to long lasting distortions in the tax system since tax increases, even if presented as temporary, often prove difficult to reverse.

including for an articulation of context-relevant rules, would enhance not only the effectiveness of a rule-based fiscal framework, but more broadly the quality macroeconomic policy design and implementation.

In the end, the effectiveness of a rule-based fiscal framework depends on a key pre-requisite: political commitment. Fiscal rules can provide a framework to set alternative policy options and increase the legitimacy of certain policy choices, but they cannot be a substitute for the willingness of the authorities, and the public at large, to maintain fiscal discipline.

SOVEREIGN WEALTH FUNDS

Sovereign wealth funds (SWFs) have long been advocated as an important rules-based fiscal policy instrument to manage the use of government revenues and help overcome political economy problems that favor excessive consumption and address the issue of inter-generational equity.

Eight island countries in the Pacific have, or have had, sovereign wealth funds (SWF) and trust funds (TF), financed through the exploitation of natural resources (Kiribati, Nauru, and Timor-Leste), by donor grants (Federated States of Micronesia, Marshall Islands, Palau, and Tuvalu), or by fee revenue (Tonga). In other regions, all SWFs have their origins from natural resources (Bahrain, Botswana, Brunei, Equatorial Guinea, Gabon, Qatar, and Trinidad and Tobago).

The traditional objectives of SWFs in small states are macroeconomic stabilization to insulate the economy from large fluctuations in prices and revenues, and stable budget financing to smooth out the government budget fluctuations. SWFs in small states are also viewed as a way of providing a permanent income flow to preserve wealth for future generations, achieve budgetary self-reliance, and address inter-generational equity.

However, in practice, only few Funds in small states have been able to achieve all their stated objectives. Nauru's fund, which was designed for providing permanent income, is now closed. The fund established in Kiribati, which grew to roughly eight times its GDP, has experienced substantial draw downs in recent years as well as value losses, and can now give little permanent income support.

The funds in Marshall Islands, Federated States of Micronesia, and Palau, which were established as part of the Compact of Free Association with the United States to replace fully compact grants, are also unlikely to maintain fiscal sustainability once grants under their Compact with the US are discontinued in 2024. Tuvalu fares somewhat better in terms of fiscal sustainability but the outlook is heavily dependent on the continuation of large donor grants, and is vulnerable to external shocks.

Some of the remaining small states funds, which have their origins from oil receipts, have achieved a sizable volume such that it would provide not only room for macroeconomic stabilization but also some permanent income flow for future generations. A key challenge for such countries, like Timor-Leste, is to build on recent efforts to further strengthen the quality of public expenditure.

QUESTIONS FOR DISCUSSION:

Many fiscal problems faced by small economies stem from their vulnerability to natural disasters and exogenous shocks. Can fiscal rules provide compelling policy options for small states? What rules are the most useful and effective in a small states context?

Despite significant aid flows, some small states continue to run large fiscal deficits to undertake critical investment. What lessons can be learned from the experience of SWFs? Are SWFs a viable option for small states given the experience to date?

Where do Ministers see the need for capacity building to enhance the effectiveness of a rule-based fiscal framework?

Description of the rules	
Country name	Key elements of fiscal rules
Antigua and Barbuda; Dominica; Grenada; St. Kitts and Nevis; St Lucia; St. Vincent and the Grenadines	<p>ER: Expenditure rule</p> <p>RR: Revenue rule</p> <p>BBR: Budget balance rule</p> <p>DR: Debt rule</p> <p>ER: Expenditure rule</p> <p>RR: Revenue rule</p> <p>BBR: Budget balance rule</p> <p>DR: Debt rule</p>