What is of greater importance is that you should work under the assumption that you will not get it right first time around. Thus the second lesson is that a basis for altering the structure of the market should be enshrined with legislation or licences. The privatisation of the electricity industry was based upon a very static view of competition and technological development. In telecommunications technological development could render networks obsolete in the near future. While this is less likely in energy technology will, however, probably make it much more easy to incorporate competition and reduce the cost of networks. Already the cost and the minimum efficient size of CCGT generating sets is falling and gas pipes are increasingly be made of plastic as opposed to steel. Thus even where the structure is right first time around, some future development may necessitate a restructuring of the industry.

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FISCAL IMBALANCES AND EXTERNAL DEFICITS IN THE MARSHALL ISLANDS

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Abstract. The paper analyses the fiscal imbalances and external deficits of Marshall Islands. Fiscal expansion during 1986-1995 was mainly due to Compact assistance from the United States of America as well as grants from other bilateral sources. In addition, the country resorted to external borrowing from 1991 on the basis of future Compact assistance receipts, which also contributed to overall budget deficits and current account deficits in the external accounts. The analysis indicates that the policy measures have to be directed towards reduction in public expenditures and growth through better resource allocation and expansion of productive capacities in the economy.

Introduction

Fiscal imbalances among the Pacific island countries (PICs) have become common in recent years. Although none of these island countries has come into serious difficulties so far, mainly thanks to the substantial annual bilateral assistance in terms of generous grants for supporting their recurrent budgets as well as capital expenditures, the recent decline in external aid flows does not augur well. Various studies by international lending agencies (World Bank 1995) have alerted the PICs to put their houses in order so that the painful strains and stresses associated with eventual adjustments to a more orderly fiscal discipline can be avoided.

Among PICs, three island countries in Micronesia in the north Pacific namely, the Federated States of Micronesia (FSM), the Republic of Marshall Islands (RMI) and the Republic of Palau (RP), which were former Trust Territories of the United States of America, have signed the

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Compacts of Free Association (CFA) are receiving annual grants. The notion underlying the basis of CFA assistance to the three island states is that the annual grants over the fifteen-year period would contribute to the fostering of budgetary self-reliance. Further, it was expected that the annual CFA grants would facilitate their smooth transition to full fiscal independence.

The annual grants under CFA to RMI have been $53 million for the first five years effective from 1986, $49 million for the next five years, and then $46 million for the last five years. Negotiations are underway for extending the CFA for a further period of ten years.

While it is too early to make an assessment of RP's policies for smooth transition, the experiences of both FSM and RMI indicate that the goal of fiscal self-sufficiency has still remained elusive. Their expansionary fiscal stances during the last ten years have led to macroeconomic imbalances manifested in severe external trade deficits which have been masked by the annual capital flows under the Compact.

The objective of this paper is to analyse the causes which contributed to macroeconomic imbalances of RMI as a case study, with a view to arriving at a set of implementable policy reforms for reaching the avowed objective of fiscal reliance. The paper is organised in four sections. Following this introductory section, the paper gives background information about RMI and describes the growth of the public sector of this country. Section three gives a brief account of the macroeconomic imbalances and their determinants. The final section offers certain conclusions and indicates policy measures.

Background

The RMI faces both physical and human resource constraints similar to those confronted by other island countries in the South and North Pacific. These constraints stem out of limited natural resources and high population densities on small islands scattered over vast expanses of the Pacific and Ocean. The RMI's productive base consists of coconut and copra processing, subsistence farming and deep sea fishing. This narrow productive base, shortages of skilled labour and the resultant high wage

structure and remoteness from external markets have all constrained RMI's economic growth.

Although the country's real GDP grew at a modest average of 2.4 percent per year over the ten-year period (1985/86–1994/95), there were noticeable annual fluctuations in growth. The years of high growth rates coincided with the beginning of inflows of Compact assistance; and the low rates of growth towards the end of the ten-year period of study reflected the emerging strains of fiscal and external imbalances developing over the period. During the ten-year period, per capita real GDP recorded a negative growth rate of 1.4 percent. The reason is obvious: the population grew at a faster rate of 3.8 percent per year as compared to real GDP's growth rate of 2.4 percent.

Growth in Public Sector

Since reliable data relating to total domestic investment and its composition in terms of private and public investment are not available, direct quantitative comparison of the role of public sector with the private sector is not possible. Therefore, the growth in public sector is assessed in terms of the ratio of public sector expenditures to GDP. For facilitating comparison of growth over time, economic variables including public sector expenditures and revenues and grants have been scaled to GDP, following the well-accepted procedure in similar studies elsewhere (Lindauer and Velinchik 1992).

During the first seven years (1985/86–1991/92), there was a clear upward trend in the dominant role of the public sector (Table 1). The ratio of public sector's total expenditure to GDP rose from 72 percent in 1985/86 to 112 percent in 1991/92. This trend was reversed in the next four years, due to decline in the ratio of external aid (defined as grants, comprising both Compact and non-Compact grants from USA and grants from other sources, including bilateral and multilateral agencies, which do not involve any repayment obligations) to GDP beginning from 1990/91. This ratio peaked at 76 percent in 1989/90 decreasing in the next five years to 43 percent of GDP in 1994/95.

The annual domestic resource mobilisation efforts can be seen by analysing the trends in total revenue without taking external aid into account.

Table 1
Total Expenditure, Revenue and Grants as Percent of GDP

Year	1985/86	1986/87	1987/88	1988/89	1989/90	1990/91	1991/92	1992/93	1993/94	1994/95
Total Expenditure	72.4	90.8	90.2	99.1	107.0	104.6	112.4	101.2	89.3	85.0
Capital	3.0	19.4	23.6	29.2	32.7	24.8	31.9	21.3	16.2	23.1
Current	69.4	71.4	66.5	69.9	74.3	79.8	80.4	79.9	73.1	61.7
Total Revenue										
With Grants	67.4	110.9	109.5	101.7	110.9	96.1	87.4	87.8	80.0	71.7
Without Grants	25.3	26.0	28.6	32.5	35.0	33.6	30.8	33.6	31.0	29.1
Total Grants	42.1	84.8	80.9	69.2	75.9	62.5	56.6	54.2	48.9	42.6
Compact	0.0	58.8	61.5	57.2	58.2	51.5	41.0	39.6	37.9	36.2
Others	42.1	26.0	19.4	14.9	17.7	10.9	15.5	14.6	11.0	6.4
Tax Revenue	19.1	18.0	17.1	20.6	20.0	20.5	21.1	23.4	20.5	20.7
Non Tax Revenue	6.2	8.0	11.4	11.9	14.9	13.1	9.7	10.3	10.6	8.4
Overall Balance	-5.1	19.9	19.2	2.5	2.2	-8.4	-25.0	-13.3	-9.3	-13.2
Without Grants	-47.2	-64.9	-61.7	-66.7	-73.7	-70.9	-81.6	-67.5	-58.2	-55.8
Without Compact	-5.1	-38.9	-42.3	-54.7	-56.0	-59.9	-66.0	-52.9	-47.2	-49.4
Without Other Grants	-47.2	-6.1	-0.2	-12.4	-15.5	-19.3	-40.5	-27.9	-20.3	-19.6

Sources: Republic of Marshall Islands (1997) and author's calculations

Table 2
Components of Tax Revenue
(As Percent of Total Tax Revenue)

Year	Income Tax	Import Duty	Gross Receipt	Fuel Tax	Others
1985/86	45.4	35.2	14.8	2.8	1.9
1986/87	49.1	40.9	9.0	0.1	0.9
1987/88	50.4	38.9	8.0	1.8	0.9
1988/89	56.2	32.8	6.6	3.6	0.7
1989/90	44.2	39.9	3.6	5.1	7.2
1990/91	50.3	40.1	0.0	4.1	5.4
1991/92	49.7	33.5	13.2	3.0	0.6
1992/93	41.3	37.8	15.8	3.1	1.5
1993/94	41.2	36.3	17.6	3.3	1.6
1994/95	40.2	34.5	16.5	6.2	3.1

Source: Republic of Marshall Islands (1997) and author's calculations

In 1985/86, RMI's own effort yielded domestic revenue equivalent to 25 percent of GDP and in 1989/90 it recorded a maximum of 35 percent. However, the proportion declined to 29 percent of GDP in 1994/95 (Table 1). The contribution of taxes has been around 20 to 21 percent of GDP, whereas non-tax revenue which recorded a rise from 6 percent of GDP in 1985/86 to 15 percent in 1989/90 was about 8 percent in 1994/95.

The share of income tax in total tax revenue rose from 45 percent in 1985/86 to 56 percent in 1988/89 and showed a declining trend thereafter. The share of consumption taxes such as fuel and gross receipt taxes recorded increases (Table 2). Among non-tax revenue measures, the share of fishing rights in total non-tax revenues increased, after an initial decrease in the first five years of the study period. The share of philately revenue declined over the period (Table 3).

Recurrent expenditures, which include public sector wages and salaries and other housekeeping expenditures relating to the maintenance of public assets, rose from 69 percent of GDP in 1985/86 to 80 percent in

Table 3
Components of Non-Tax Revenue as a Percentages of Total Non-Tax Revenue

Year	Fishing Rights	Philately Sales	Interest Income	Fees & Charges	Others
1985/86	22.2	8.3	5.6	33.3	30.6
1986/87	16.3	10.2	20.4	20.4	32.7
1987/88	16.0	0.0	33.3	33.3	17.4
1988/89	16.5	2.5	36.7	13.9	30.4
1989/90	11.7	3.9	37.9	14.6	31.9
1990/91	20.2	3.2	27.7	20.2	28.7
1991/92	19.5	3.9	39.0	1.3	36.3
1992/93	24.4	2.3	31.4	16.3	25.6
1993/94	36.2	3.2	14.9	17.0	28.2
1994/95	38.0	2.5	19.0	24.1	16.4

Sources: Republic of Marshall Islands (1997) and author's calculations

1992/93 and declined in the later two years (Table 1). Wages and salaries, reflecting public sector employment, were around one third of the recurring expenditures (Table 4) and were nearly 96 percent of total government expenditures in 1985/86. The proportion declined in subsequent years, not because of any deliberate decrease in recurrent expenditures, but because of a relative rise in the ratio of capital expenditure to total expenditure (Table 1).

Government Savings, External Aid and Fiscal Balance

The recurrent budget balance (difference between revenue and current expenditure) had been in deficit during the ten-year period, signifying negative savings and indicating the absence of any contribution towards capital expenditure (Table 1). Increased efforts in terms of reducing government consumption and additional domestic resource mobilisation, especially in the later years of the ten-year period, contributed

Table 4
Government Expenditures: Capital and Recurrent Expenditures with Various Components

Year	Cap Exp. (as % of Total Exp.)	Rec. Exp. (as % of Total Exp.)	Wages and Salaries (as % of Recurrent Expenditures)	Goods and Services (as % of Recurrent Expenditures)	Interest Payments (as % of Recurrent Expenditures)	Subsidies (as % of Recurrent Expenditures)
1985-86	4.2	95.8	29.8	42.3	13.8	9.2
1986-87	21.4	78.6	29.3	43.7	12.1	14.9
1987-88	26.2	73.8	32.6	33.9	12.8	15.9
1988-89	29.5	70.5	33.4	43.5	13.1	12.3
1989-90	30.5	69.5	32.2	42.2	10.3	12.3
1990-91	23.7	76.3	30.7	38.9	15.3	20.1
1991-92	28.4	71.6	29.5	35.2	10.2	19.6
1992-93	21.0	79.0	29.0	39.4	15.3	16.2
1993-94	18.1	81.9	30.5	42.6	10.2	16.8
1994-95	27.1	72.9	30.0	42.6	13.3	14.1

Sources: Republic of Marshall Islands (1997) and author's calculations

towards reducing the deficit and thus the size of negative government savings.

Since government savings were negative, government capital expenditures were actually financed by external aid, a part of which was used for government consumption expenditure as well. Thus, external aid has been a great support to RMI's efforts to meet the growing fiscal expenditures, both consumption and capital. External aid was 85 percent of GDP in 1986/87, which marked the first year of Compact assistance, which was on its own 59 percent of GDP. However, the relative contribution of external aid declined over the period to 43 percent of GDP and the share of Compact assistance also got reduced to 36 percent of GDP in 1994/95 (Table 1).

Capital expenditure which was only 3 percent of GDP and 4 percent of total expenditures in 1985/86. It registered significant increases in the next four years, reaching a high proportion of 33 percent of GDP in 1989/90. Most capital expenditures were investments in power generation,

Table 5
External Debt as a Percentage of GNP

Year	Debt/GNP	Debt Service/Exports
1986/87	72.4	15.0
1987/88	68.5	41.7
1988/89	74.7	28.9
1989/90	66.6	35.2
1990/91	99.5	32.2
1991/92	117.9	40.0
1992/93	173.5	46.0
1993/94	190.2	44.2
1994/95	164.8	43.1

Source: World Bank (1995) and author's calculations.

fisheries development, sewerage, water supply and other physical infrastructures. However, a noticeable decline since 1990-91 is observed in the ratio of capital expenditures to GDP. It is obvious that most of the grants seem to have been diverted to finance government consumption rather than public investment. This trend was facilitated by a newly found way of financing the overall deficit through external borrowing. In 1991, nearly $66 million was borrowed by issuing a bond guaranteed by future Compact receipts. Similarly three more external borrowings were resorted to, for a total debt of $100 million. The external debt expressed as a ratio of Gross National Product (GNP), which is equal to GDP plus net factor income from abroad, rose from 72 percent in 1986/87 to 100 percent in 1990/91 and continued to increase steadily thereafter (Table 5). The increases in debt servicing obligations then had to be accommodated by the government in the recurrent budget each year.

Overall Fiscal Balance and External Accounts

The overall fiscal balance, defined as the difference between total revenue (government's own revenues and external aid) and total expenditure has been in deficit since 1990/91. The position would have been even worse without external aid. In 1991/92, the deficit without Compact

assistance and grants would have been 82 percent of GDP. Despite tightening fiscal expenditures and improving domestic revenue mobilisation in 1994/95, the corresponding overall balance without Compact assistance and grants was 56 percent of GDP.

Private saving of the Marshall Islands is negligible. Since domestic absorption in terms of private and public sector consumption and investment is far in excess of domestic supply, fiscal imbalances tend to get reflected in deficits in the balance of payments (BOP) as the saving of the private sector is insufficient to finance private investment and fiscal deficits. The deficit in the current account of BOP is relevant here. Table 6 presents the details of current account balances in BOP of RMI, all expressed as percentages of GDP.

The current account balance before official transfers has been in deficit all along. The highest deficit before official transfers was recorded at 80 percent of GDP in 1989/90. Official transfers representing Compact and other grants amounted to about 92 percent in 1987/88 and decreased to 59 percent of GDP in 1993/94. If official transfers are included, the annual current account balances are in surplus until 1990/91 and then became negative in 1991/92 and thereafter.

The likely adverse impact of both fiscal and current account deficits in terms of inflation was comfortably cushioned by the inflows of real resources in terms of official transfers. Since RMI has adopted the same currency as that of USA, there was no pressure on the exchange rate for devaluing the currency. The only pressure is to run down reserves and in the absence of such reserves, external borrowing is considered the easiest way to finance the current account deficit. Long-term implications of debt servicing, diverting the current resources from productive purposes and the resultant adverse effects on growth in the countries in the South Pacific region are documented elsewhere (Jayaraman 1996). Although RMI has been successful in resorting to external borrowing against future Compact receipts, further possibilities are limited as the Compact assistance itself is scheduled to be phased out by 2001. Negotiations are underway to have the Compact assistance in same form or another. The credibility of RMI as a debtor is at stake.
In these circumstances, major fiscal adjustment in terms of reduced domestic absorption is called for in the next four years which mark the

Table 6
Current Account Balance in the Balance of Payments as Percentage of GDP

	1987/88	1988/89	1989/90	1990/91	1991/92	1992/93	1993/94
Trade Balance	-85.6	-87.5	-88.4	-66.2	-64.3	-63.6	-57.6
Exports	3.2	3.6	3.9	12.2	12.2	9.6	20.8
Imports	-88.8	-91.1	-92.3	-78.4	-76.5	-73.3	-77.8
Net Services	17.1	19.9	10.0	6.7	2.0	1.7	4.0
Unrequited Private Transfers	1.5	1.5	1.4	1.8	1.8	1.9	1.8
Current Account Balance excluding Official Transfers	70.1	-69.3	-80	61.3	-64.0	-63.9	-54.8
Official Transfers	91.8	84.6	90.3	71.6	63.9	62.9	59.2
US Grants	91.5	84.3	90.1	70.8	62.5	61.5	57.3
Others	0.3	0.3	0.2	0.8	1.4	1.4	1.9
Current Account Balance including Official Transfers	21.8	15.4	10.3	10.3	-0.1	-1.0	4.4

Source: Republic of Marshall Islands (1997) author's calculations

transition period towards the non-Compact period beginning from 2002.

The present author has conducted a study (Jayaraman, 1998) which gave a retrospective look at simulated deficits without official transfers, based on an empirical investigation of the quantitative data for the years 1986 – 1995. The model was based national accounting identities relating to the current account in the country's BOP, showing that the current account balance in BOP can also be interpreted as the sum of net government saving and net private saving. This also indicates that macroeconomic equilibrium is achieved when private and public savings minus total domestic investment equals the current account in BOP. Based on the theoretical discussion (Bartoli 1989), the current author proposed a simple model for finding out the determinants of changes in the current account in BOP.

The objectives of the model were to investigate: (i) the factors influencing the current account balances; (ii) the role of fiscal policies in determining current account balances; and (iii) applicability of the model for policy formulation.

On the basis of this model the present author conducted a simulation exercise to simulate current account balances, which confirmed that fiscal expansion during the 1986 – 1995 led to far greater domestic demand than the actual domestic supply could absorb.

The annual Compact assistance and other grants sustained the domestic imbalance to a certain extent by reducing the external deficits. Since the level of external assistance was found inadequate in the later years of the period under study, steady increases in recurrent budget and investment requirements for capacity building for growth had to be met with by external borrowing which was guaranteed by future Compact assistance receipts.

The results were unfavourable widening external deficits, reduced growth, and mounting external debt servicing obligations which were to be accommodated within the budget already constrained by lack of domestic resources as well as inefficient allocation of resources due to distortions in relative prices.

Conclusions

The policy implications of this study clearly indicate the need for correcting the imbalances before total loss of country's creditworthiness. The normal recourse to devaluation of the domestic currency for increasing the competitiveness of exports of goods and services, including tourism, and discouraging imports is not available to RMI, as the country has adopted the US dollar. In these circumstances the only way open to decision makers is to implement a macroeconomic adjustment programme before the external finance is exhausted and the economy badly distorted.

The adjustment programme aiming at reducing current absorption and raising future productivity and growth potential would have two components: (i) demand management for reducing public expenditures, thereby reducing the demand for non-traded goods and services and demand for traded goods, especially consumption imports; and (ii) structural adjustment for growth by improving economic efficiency through promoting resource allocation and expanding productive capacities of the economy.

Aware of the need for financial support for carrying out the reform programme, RMI got a loan approved in December 1996 for an amount of $12 million from the Asian Development Bank (ADB). The principal objectives of the loan are achieving fiscal stabilisation in the short term by balancing the budget through expenditure reduction and greater mobilisation of revenue, and achieving structural stability in the medium term by reducing the size of the civil service and subsidies to public enterprises by broadening the tax base. Besides these two objectives which have a direct bearing on public finances, the ADB loan assistance also required introduction of measures which would encourage promotion of the role of the private sector, which is expected to absorb the retrenched civil servants.

The loan proceeds would be utilised for financing a wide range of eligible imports, subject to a list of non-essential imports and the counterpart funds would be used for (i) providing separation benefits to and the re-training of retrenched staff towards their gainful employment in the private sector, or for initiating enterprises on their own; (ii) retiring that part of the government's short-term external debt which was incurred

under least favourable conditions such as high interest rates; and (iii) establishing a Trust Fund, similar to the Tuvalu Trust Fund (Saitala, 1995), to which donors would be encouraged to contribute with the objective of utilising the interest income for meeting annual budgetary needs.

However, there are some essential requirements for the proposed public sector reform programme to succeed: (i) a commitment to implement reduction in civil service; (ii) courage to close non-profitable public enterprises; (iii) willingness to privatise the profit making public enterprises; and (iv) promotion of public sector investment and initiatives. Unless these requirements are fully met, the chances of successful implementation of the proposed public sector reforms appear to be bleak.

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