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A budget funded by foreign aid

T.K. JAYARAMAN

Which is better for financing the budget: foreign aid or debt?

That is always the question before Pacific island countries (PICs) each year. The dilemma becomes acute when the future is uncertain with mounting public debts and rising debt servicing obligations.

Tonga's Finance Minster chose aid as a better alternative for financing the country's 2014-2015 budget. It is also Tonga's biggest budget in country's history. Total budget, with growth enhancing capital investments, costs 483.7 million Pa'anga (US$257.7 million).

Role of aid

About 59 percent of the budget (US$152 million) is funded by aid and 41 percent (US$105.7 million) funded domestically.

While presenting the budget Finance Minister referred to the implications of Tonga's rising debt: total debt 43.5 percent of GDP, dominated by external debt (40 percent) .

Although China postponed the repayment of the loan (US$119 million) for another ten years borrowed for reconstruction of the 2006-riots affected Nuku'alofa, annual debt servicing obligations remain. About 50 million pa'anga (US$ 27 million) has to be annually mobilized.

The China loan was on-lent to owners of properties in Nuku'alofa destroyed by the 2006 riots. Some beneficiaries have not executed on-lending agreements with government. Some who signed the agreements and started deriving rental incomes from renovated properties have yet to begin paying their dues.

An IMF and World Bank Debt Sustainability study has changed Tonga's rating from high to moderate risk of debt distress due to the improvement of the Country Policy and Institutional Assessment rating from 'Weak' to 'Medium'. However, it advises a cautious approach towards new non-concessional loans by referring to repayments on loans from the China EXIM Bank. The study also warns of rise in debt service burden and currency risk. About 60 percent of external debt is in one currency, the Chinese.

A prudent blend

Tonga prefers the blend: 59 percent by aid and 41 percent by domestic resources. It is indeed a prudent approach to debt management considering the fact that debt service ratio (ratio of servicing obligations in foreign exchange as a percent of Tonga's export earnings) is also on the rise, close to 8 percent.

The blend of development assistance (loans and grants) adopted by Asian Development Bank (ADB) in regard to highly indebted nations is relevant here. External debt of Marshall Islands, with revenue of only US$107 million is high: US$120 million (over 70 percent of GDP). It has 13 loans owed to ADB amounting US$73 million and US$50 million to US. Last month, ADB decided that Marshall Islands should be assisted only with grants: no more new loans.

Some concerns

While expressing his concern over the reliance of Tonga on foreign aid for the budget, Dr. Sitiveni Halapua, a Tongatapu People's Representative, compared it to "building a family home with donor's fund so that at the end, one would feel that the donor owned the home".

Is Dr. Halapua correct?

Aid always has played an important role in the history of growth and development of PICs. Before 1990s, the bilateral aid was for both recurrent and capital parts of the budgets. The shift in emphasis came in the 1990s soon after the end of the Cold War. Traditional donors discontinued supporting recurrent expenditure and started assisting only capital projects.

Donors know PICs are highly dependent on food and fuel imports with limited range of their exports to pay for imports. They are aware PICs need to be assisted with aid and other means of generating valuable foreign exchange for investment in physical and social infrastructure. Innovative measures to improve remittances and non-debt creating capital inflows, including seasonal labour mobility schemes, along with aid for trade are in place.

Rising capital inflows are part of globalization. The commitment on the part the developed countries made 35 years ago to set apart a minimum 0.7 percent of their national outputs as official development assistance still holds good.

Less aid inflows do not make any nation more independent or more sovereign. What is advised against is dependence on or debt exposure to a single country.

In Tonga's case, sources of aid are well diversified. They range from Australia, EU, Japan and New Zealand to UNDP and WHO.

Therefore, Dr Halapua's comparison: Tonga's budget to "building a family home with donor's fund so that at the end, one would feel that the donor owned the home", is not correct. As an economist, he knows what makes sense for a household may not make sense for a nation.

He spoke as a politician sitting in the opposition.

Dr T.K. Jayaraman is a Professor teaching economics at Fiji National University, Nasinu campus.
This article was first published in Fiji Sun on June 1, 2014. His website is: www.tkjayaraman.com