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IMF Fiscal Policy Engagement in Small Developing States

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ABBREVIATIONS

ADB	Asian Development Bank
BOP	Balance of Payment
CBI	Citizenship by Investment
CARTAC	Caribbean Technical Assistance Center
CC	Climate Change
CCPA	Climate Change Policy Assessment
CD	Capacity Development
DSA	Debt Sustainability Assessment
EM-DAT	International Disaster Database
FAD	Fiscal Affairs Department (IMF)
FTE	Full-Time Equivalent
GDP	Gross Domestic Product
IDA	International Development Association (concessional arm of the World Bank)
LEG	Legal Department (IMF)
LIC	Low-Income Country
MAC	Market Access Country
MCM	Monetary and Capital Markets Department (IMF)
MTFF	Medium-Term Fiscal Framework
ND	Natural Disaster
ND&CC	Natural Disaster and Climate Change
NTF	National Transformation Fund
PFM	Public Financial Management
PFTAC	Pacific Financial Technical Assistance Center
PRGF	Poverty Reduction and Growth Facility
RAM	Risk Assessment Matrix
RCDC	Regional Capacity Development Center
RCF	Rapid Credit Facility
RFI	Rapid Financing Instrument
SDS	Small Developing State
SGN	Staff Guidance Note
SIP	Selected Issues Paper
SOE	State-Owned Enterprise
STA	Statistics Department (IMF)
TA	Technical Assistance
VAT	Value-added Tax

EXECUTIVE SUMMARY

This paper evaluates the IMF's engagement on fiscal policy issues with small developing states (SDS) over 2010–2020. Several factors make this engagement interesting, and thus make an evaluation challenging. First, the evaluation period begins soon after a global financial crisis which left many SDS heavily indebted and grappling with the fiscal policy issues associated with debt sustainability. Second, during the evaluation period, the Fund's understanding of how SDS differed from other member countries evolved markedly in terms of the challenges they faced in confronting macroeconomic policy; this led to the issuance of two Staff Guidance Notes (SGNs) on SDS in 2014 and 2017. Third, the period was marked by an intensification of natural disasters (NDs) (seemingly fueled by the pace of climate change). This required rapid adaptation by the countries themselves and by the Fund in the way it provided policy advice and financing. Fourth, the fiscal sector was particularly disrupted by these issues: while SDS revenues are critically dependent on a narrow economic base, their expenditure priorities not only mirrored those of most Fund members but were accentuated by the challenge of responding to the impact of NDs. Finally, the final year of the evaluation period was marked by the COVID-19 pandemic, which further disproportionately damaged the economies (and the fiscal sectors) of at least half of SDS.

This paper seeks to evaluate how the Fund worked with SDS to respond to their fiscal policy challenges as they evolved during the period. It recognizes that SDS are not homogeneous; while many rely on a narrow tourism base, others are blessed (but also cursed) with the challenge of managing either sizeable (but still finite) natural resource assets or significant but similarly finite financial legacy assets. Some SDS proved particularly challenged in working with the Fund as a consequence of their characteristics, including limited human resources and a low political capacity for policy adjustment. The Fund's involvement thus needed to be tailored to the differential needs of these situations.

The evaluation covers the three principal channels of the Fund's engagement with its SDS members: surveillance, Fund financing, and capacity development, recognizing that these divisions mask the highly interconnected and synergistic relations across these channels. On surveillance, the evaluation most importantly examines: (i) the efforts by the staff to introduce approaches to strengthen and elaborate the fiscal policy framework; (ii) the challenge of coping, not only with the discrete shocks that occurred from NDs, but with the economic and financial portent of climate change (CC) for many SDS; (iii) the challenges posed by the tension between SDS policies to foster growth through investment and the debt sustainability risks posed by such initiatives; (iv) the issues raised by SDS policy initiatives to strengthen their fiscal resilience through policy innovations, such as Citizenship by Investment (CBI) Schemes; (v) the problems encountered in dealing with the fiscal burdens imposed by the inefficient state-owned enterprises which often dominate the economic landscape of SDS; and finally (vi) the approach of the Fund in assessing the sustainability of the debt position of SDS, given the highly varied risks to which their economies are exposed.

The Fund's financial involvement through its Fund-supported programs primarily reflected an effort to address acute debt weaknesses. Most SDS using such programs ultimately saw debt ratios significantly reduced, often with support from the Fund for debt restructuring initiatives as programs encouraged fiscal reforms and consolidation. The Fund also provided important emergency financial support in the context of natural disasters and the COVID-19 pandemic. Finally, with SDS limited in human capital by virtue of their small size, they also benefit from frequent interactions with the Fund's principal vehicles for capacity development, both from headquarters (training, technical assistance and seminars) and its technical experts based in their regions at Regional Capacity Development Centers.

Overall, the paper concludes that the Fund's fiscal policy advice provided considerable value added to SDS, particularly after the increased attention to SDS relevant issues after the issuance of the 2014 Staff Guidance Note. Moreover, the evaluation suggests that Fund staff have displayed great perseverance to help countries make progress on fiscal resilience and debt sustainability in the face of natural disaster and pandemic setbacks that have gone well beyond what risk assessment matrices anticipated. Surveillance and capacity development have given SDS conceptual tools to manage and strengthen their fiscal policies and respond to the multiple challenges of CC, equity disparities, and human capital limitations. Reforms to the debt sustainability assessment (DSA) methodology are now beginning to reflect greater sensitivity to climate-related risks, though there are still limitations in the DSA methodology in the SDS context that remain to be addressed.

At the same time, traction of IMF work on fiscal issues in SDS has been mixed. In part, this reflects the limited capacity in SDS to absorb and advance initiatives to address underlying problems beyond the day-to-day challenges of managing fiscal policy. In addition, while Fund economists better understand the challenges and potential risks to be confronted, sometimes disappointing experience with the efforts to date have exposed structural issues that will need further work by the Fund to best support SDS in managing their finances, notably regarding budgeting for natural disaster risks and asset-liability management for countries with significant sovereign wealth funds and natural resource endowments. Again, the pandemic has only worsened the state of these finances. Finally, the IMF's discussions on CC have laid the groundwork for the integration of issues of climate-related NDs into fiscal policy discussions. But the challenges from CC for fiscal policy and sustainable development have only begun to be reflected in the Fund's surveillance advice. Going ahead, two relevant challenges will be: (i) ensuring that the analytical toolkit and advice is well adapted to what SDS can absorb and utilize; and (ii) ensuring more consistent application of the new toolkit across potentially vulnerable countries.

I. INTRODUCTION

1. The IMF's 34 members classified as Small Developing States (SDS) confront a number of daunting fiscal challenges in common, each in its own distinct circumstances (IEO, 2022). Due to their small population, geographic and economic size, proneness to shocks and physical distance from major global economic and financial markets, SDS generally face low and narrow revenue bases. Moreover, weak administrative and human resource capacity limit their ability to build fiscal institutions and conduct and sustain effective fiscal policy. These members are also particularly susceptible to natural disasters (NDs) (Lombardi and Rustomjee, 2022), often resulting in large, frequent and unanticipated fiscal shocks and in excessive public debt accumulation. The COVID-19 pandemic—a biological ND—has severely affected many SDS, setting back progress achieved by SDS in fiscal policy over the decade of the evaluation.

2. The IMF has recognized both the common fiscal challenges and their consequences for the conduct of fiscal policy and management of SDS public debt. A 2013 IMF Board paper (IMF, 2013a) reviewed the weakening fiscal and debt positions of small states following the global financial crisis and emphasized the need for the institution to take stock of its approach to addressing the fiscal policy challenges faced by SDS. This precipitated the firming up of an agenda and a focus for richer engagement by IMF staff on fiscal policy and debt issues in its surveillance, financial support and capacity development (CD) with SDS. Subsequent Staff Guidance Notes (SGNs) in 2014 and in 2017 both prioritized fiscal policy as a key component in IMF engagement with SDS (see IMF, 2014; 2017d), emphasizing that effective Fund fiscal policy advice, supported by appropriate capacity development (inter alia through technical assistance) can help these members address their macroeconomic policy objectives, enhance growth, promote equity and the realization of their developmental goals and strengthen their ability to address exogenous shocks. Both SDS SGNs (IMF, 2014; 2017d) underscored the need to reduce debt burdens to a sustainable level and the relevance of "sustained fiscal consolidation with supporting policies and structural reforms." The 2017 SGN mirrored the 2014 SGN while noting that the effects of climate change (CC) would further stress the fiscal resilience of SDS.

3. Over the evaluation period 2010–2020, IMF engagement on fiscal policy issues was extensive, specialized and tailored. It was extensive, featuring all aspects of Fund engagement with its membership, including policy guidance, research, surveillance and policy advice, inclusion of fiscal policy measures in Fund-supported programs, as well as CD. It was specialized, building on dedicated staff attention in several specific policy areas, including tax and expenditure policy, revenue administration, public financial and investment management, development of macro fiscal policy frameworks, attention to state-owned enterprises (SOEs), debt risk management, and response to the fiscal challenges arising from the impact of natural disasters and climate change (ND&CC). And it was tailored, with evidence of particular attention to four groups of SDS manifesting specific characteristics beyond their size, viz., countries highly dependent on tourism as a critical source of revenue; those largely dependent on revenues from natural resource

endowments; remote Western Pacific microstates, with significant financial legacies; and several SDS that proved to be adjustment-challenged.

4. The paper considers the following key evaluation questions: (i) Was the Fund's policy advice on fiscal policy to SDS consistent with staff guidance notes and other Fund documents and were experiences and lessons learned during the course of the evaluation period incorporated in later guidance notes? (ii) Was Fund engagement on fiscal policy well-tailored to the specific challenges facing SDS and to country-specific circumstances? (iii) How well did specific surveillance tools, including Debt Sustainability Assessments (DSAs) work in the SDS context? (iv) How did Fund engagement adapt to emerging issues, including innovations in fiscal policy in SDS and increasing challenges to fiscal resiliency due to NDs? (v) Was fiscal policy advice consistent and even-handed across regions and countries? (vi) How did the Fund engage with SDS on fiscal issues arising from the response to the COVID-19 pandemic?

5. The paper is organized as follows: Section II outlines the key fiscal policy challenges faced by SDS due to small population and economic size. Section III identifies the Fund's approach to fiscal policy engagement with SDS and outlines the focus and coverage of Fund engagement, including in helping to address risks arising from NDs and CC (or together, ND&CC). Section IV evaluates the IMF's bilateral surveillance and policy advice on fiscal policy issues over the evaluation period. Section V assesses the attention to fiscal policy in the context of the IMF's program engagement and lending. Section VI briefly assesses CD on fiscal policy issues.[1] Section VII assesses the application of the IMF's debt sustainability frameworks (DSFs) and DSAs, as key tools in helping achieve fiscal resilience in SDS. Section VIII outlines the Funds' immediate fiscal policy response to the COVID-19 pandemic. Section IX concludes by drawing together a number of lessons and identifies a number of challenges for Fund work on fiscal issues in SDS.

6. **Caveat on fiscal and debt data:** In commenting on fiscal developments and policy in the 34 SDS, this evaluation almost wholly relies on the data available in staff reports associated with Article IV consultations (including Selected Issues Papers (SIPs)) and Fund-supported programs. Particularly for SDS, their fiscal and debt data is sometimes incomplete and often not up to date. This thus precludes ready comparisons across SDS or years (indeed, some SDS, such as Nauru and Tuvalu, were not IMF members at the beginning of the evaluation period). Similarly, characterizations of the state of public finances or of sectoral policy emphases (by Fund staff or the authorities) can be found in these Fund documents. While they are used for argumentation and serve to illustrate policy challenges, they may not lend themselves to easy statistical measures.

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[1] This paper provides limited coverage of fiscal policy CD, which includes both TA and capacity building, as this issue is taken up in detail in de Las Casas and Balasubramanian (2022).

II. FISCAL POLICY CHALLENGES IN SDS

7. SDS face multiple common fiscal policy challenges arising from their small population and economic size. First, the economies of almost all small countries are typically undiversified, with their small economically active populations specializing in a limited number of income-generating sectors.[2] While a few small countries may benefit from a natural resource endowment, for example oil, natural gas, or forest reserves, most are reliant on the agricultural sector or on the advantages of a favourable location and climate offering potential sources of income, such as tourism for many island states, abundant fishery reserves, or rents as an entrepôt port.

8. Smallness and lack of diversity have several important consequences for SDS. First, the economies of SDS are highly tied to the fortunes of their key sector, and thus potentially subject to significant volatility. Shifts in the commodity prices of key exports or in the global demand for the key sector (e.g., tourism) can have an outsized impact on real incomes and similarly outsized effects on fiscal revenue, with disproportionate reliance on taxes on the incomes derived from the key sector or on customs duties. Shifts in prices of major imported goods (such as oil) can quickly inflate government subsidies on consumption goods. And shifts in employment in the key sector may necessitate active government efforts to assist displaced workers.

9. Almost all small states are also characterized by narrow tax bases and significant inequality in income and wealth as well as in political and economic power, further complicating the challenge of financing the state. Raising sufficient tax revenues to finance provision of a government's basic services and foster development for its citizens can be difficult, particularly for low-income SDS, forcing reliance on external assistance (grants and concessional loans) or foreign investors. In attracting foreign direct investment to strengthen the key export sector base or diversify into other sectors, many SDS have provided tax incentives and exemptions, especially when competing with other tax jurisdictions, effectively diminishing their tax base. Taxation of the wealthy is complicated by their potential exit to lower tax jurisdictions and even when governments have sought to tax the wealthy more than the poor, capital taxation has been politically and administratively challenging. A concern for equity has often led to exemptions for the goods consumed by the poor, an approach easier to administer but more costly than targeting subsidies that avoid a leakage of benefits. Many SDS also began the evaluation period reliant on distorted tax bases that were easy to administer (customs duties, turnover taxes), but typically not buoyant as the economy expanded into the services sector.

10. In addition, the human capital of most SDS governments seeking to provide a basic range of public services and manage public infrastructure is both of limited quality and depth and subject to political economy weaknesses. Those engaged in managing the fiscal sector—formulating macro fiscal policy, collecting adequate tax and customs revenue, managing both

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[2] For many microstates, with populations of 200,000 or less, the working age population employed in all sectors—government, services, agriculture, and manufacturing—may be no more than 50,000. In the smallest countries, with populations under 50,000, these numbers are obviously far smaller.

the budget and a government's assets and liabilities, assembling fiscal statistics, appraising and managing investment projects, regulating and supervising SOEs, and responding to fiscal and welfare shocks from NDs—are stretched thin. Their attention is rarely focused beyond the current fiscal year. Efforts to upgrade administrative capacity are hindered by emigration of many well-educated and trained employees. Systems for revenue and customs administration are often inefficient and not up to date. Inefficiencies may be magnified by fragmented political control across the islands of some SDS. Government employees in SDS are also likely to have an outsized political influence, often inflating the share of the government's wage bill in the budget. Governance may prove equally challenging: those most influential may use the state and its capacity to borrow for questionable spending. While these issues are not unique to SDS, their consequences in terms of a state's budget can prove disproportionately large.

11. The costs of providing core public services are higher in SDS, particularly when the population is scattered over several islands or a significant land or sea area. Transportation costs are high and realizing economies of scale difficult, with indivisibilities in capital goods raising the average per capita cost of providing core public services.

12. For SDS with a limited private sector, governments often use SOEs to provide essential services to communities, often at subsidized prices. Such SOEs play a disproportionate role in many SDS, particularly for many island states, especially those with many individual island locations. In some cases, their output represents a substantial share of GDP, with SOEs providing fuel, electricity, power, water, public transport and other key utilities. Some SDS have established airlines to provide transport services. As with central administration, managerial capacity in SOEs often proves limited and weak, resulting in inefficient operations, high costs and a low return on assets that drags on growth and deters private sector investors. SOEs often finance investments by external borrowing, sometimes guaranteed by the Government, thus being a potential source of contingent liabilities. Such debts can contribute to an SDS's overall external debt burden. Often constituting a significant source of employment, SOE wage and pension policies may distort and influence compensation policies within the civil service and the economy. Patronage and corruption can also be problematic in small countries where political decisions can be determined by the political elite.

13. On top of these day-to-day challenges, many SDS, particularly in the Caribbean and Pacific regions, face fiscal (and potentially existential) challenges from exposure to ND&CC. Low level ND events are relatively frequent and typically associated with costly relief and reconstruction outlays; others are less frequent, but with far more damaging financial consequences. Moreover, the 2010s were a decade when CC seems to have led to a noticeable increase in both the frequency and impact of NDs (Lombardi and Rustomjee, 2022).[3] Such shocks are likely to have a much more substantial effect on the fiscal position of an SDS—positive or negative—than in a larger, more

[3] Indeed, there was a Sisyphean quality to the experience of many SDS during the decade—sound economic policies upset by exogenous shocks that could not have been anticipated during most of the period, and with timelines for realizing debt targets necessarily postponed by several years from its previous incarnation.

diversified economy. Such unanticipated shocks can throw the public finances of an SDS substantially off course from a previously satisfactory fiscal trajectory.

14. Challenges to fiscal management have also arisen as SDS have sought to overcome vulnerabilities due to a lack of economic diversity by often costly investments in infrastructure designed to broaden the economic base and through significant efforts to tap countries' natural resource endowments. During the evaluation period, several SDS based their fiscal policy on such projects, with a significant escalation in public debt accumulation but with limited success in diversifying or expanding revenue and output from existing natural resource endowments, and with disproportionately large adverse impacts on fiscal management due to the relatively small size of their economies.

15. Certain important "legacy" issues also added to SDS fiscal policy challenges. The most difficult and immediate involved high public debt ratios in many SDS (mostly in the Caribbean) at the start of the decade, well in excess of "danger" thresholds, risking a loss of access to credit lines and at the very least raising risk premia on external borrowing. For these countries, the dominant fiscal challenge was to implement a fiscal adjustment strategy to bring the debt ratio down to a more manageable level. A second legacy issue that built up during the decade was the extent to which fiscal adjustment or poor fiscal management led to a lack of maintenance of vital infrastructure. This maintenance deficit has increased the need to prioritize infrastructure investment as well as to build up financial buffers to address probable NDs. A third issue for many SDS was to address the unsustainable financial position of public pension schemes, whether from poor initial design, unexpected demographic change, or mismanagement. While not unusual for many non-SDS countries, such liabilities nevertheless added to the longer-term financial risks confronting SDS with relatively weak financial positions.

16. Finally, some microstates, particularly in the Pacific, face a "fiscal cliff" in 2024, when important grant transfers are scheduled to cease. These SDS received grants, particularly from the United States, Australia and New Zealand, to finance their government operations by contributing to the creation of sovereign wealth funds that could effectively provide future income as their finite stocks of certain natural resources (notably guano) had earlier been depleted.[4] They face the fiscal challenge of managing their current fiscal policy so as to capitalize on the financial legacy or natural resource endowment by saving sufficient resources or building up real assets that could provide a self-sustaining endowment or growth capacity in support of the government's future fiscal operations. In effect, their challenge is to avoid current generations from consuming an endowment which can benefit future generations.

[4] Others face the potential threat of coral bleaching or overfishing of their fishery reserves.

III. FUND ENGAGEMENT ON FISCAL ISSUES—OVERVIEW

17. The Fund has increasingly recognized the fiscal challenge faced by specific SDS and has sought to identify specific approaches to providing fiscal policy advice and support for them. These efforts began with a 2013 macroeconomic policy staff paper (IMF, 2013a) which highlighted the key fiscal and debt sustainability challenges faced by SDS. These issues were more clearly developed in the 2014 SGN (IMF, 2014); then elaborated further in a 2015 macroeconomic policy staff paper (IMF, 2015); further referred to in a 2016 paper on NDs (IMF, 2016); and entrenched as a focus of policy guidance in a second 2017 SGN (IMF, 2017d) (Box 1). Staff has also prepared a significant number of research and working papers discussing these fiscal challenges, ranging from their sensitivity to NDs, the policy challenges of managing natural resource assets, and the fiscal management issues associated with small population bases. For examples, see IMF (2017b), Cabezon (2015), IMF (2019), Cevik and Huang (2018), IMF (2012a), Kronenberg and Khor (2016), and Nishizawa and others (2019). Together, these papers have provided the substantive foundation for the Fund's engagement on fiscal policy issues in SDS since 2013.

Box 1. Key IMF Staff Papers on Fiscal Issues in SDS: 2010–2020

IMF (2012b), *Macroeconomic Policy Frameworks for Resource-Rich Developing Countries*
Relevant for addressing fiscal and intergenerational issues in managing natural resources in SDS.

IMF (2012a), *Staff Guidance Note on the Fund's Engagement with Countries in Fragile Situations*
Principally relevant for thinking about challenges of "adjustment-challenged" SDS.

IMF (2013a), *Macroeconomic Issues in Small States and Implications for Fund Engagement*
Underscored need to revisit Fund's approach to engaging with SDS, highlighting their specific characteristics and the challenges faced by SDS microstates.

IMF (2014) and updated (IMF, 2017d), *Staff Guidance Note on the Fund's Engagement with Small Developing States*
Pivotal in highlighting how the IMF/IMF staff should engage relative to challenges posed for SDS by ND&CC. Also highlights issues arising from introduction by SDS of CBI schemes and the increased reliance on public private partnerships.

IMF (2015a), *Macroeconomic Developments and Selected Issues in Small Developing States and IMF Guidance Note for Surveillance under Article IV Consultations (2015c)*. Focused on fiscal frameworks, external devaluation, and financial inclusion issues.

IMF (2016), *Small States Resilience to Natural Disasters and Climate Change—Role for the IMF*
Important early building block in adding more sophisticated approaches to addressing issues of ND&CC.

IMF (2017b), *Building Fiscal Capacity in Fragile States*
Principally relevant for thinking about fiscal challenges of "adjustment-challenged" SDS.

IMF (2017c), *Review of the Debt Sustainability Framework in Low-Income Countries: Proposed Reforms*
Important for highlighting important risk factors to consider in DSAs for SDS challenged by ND&CC.

Cevik and Huang (2018), *Fiscal Policy: How to Manage the Fiscal Costs of Natural Disasters (Fiscal Affairs Department How To Notes)* Useful discussion on adapting fiscal policy to address the fiscal costs of NDs.

IMF (2019a), *Building Resilience in Developing Countries Vulnerable to Large Natural Disasters*
Important further discussion on the complex multi-pillar approaches to fostering short and longer-term fiscal resilience in the face of ND&CC.

18. During the evaluation period, IMF attention to fiscal policy issues represented a major focus of the Fund's surveillance and policy advice, program engagement and capacity building and technical assistance (TA) in SDS. During this period, the Fund's engagement addressed seven broad challenges faced by SDS. These included (i) tax policy and revenue administration; (ii) expenditure policy and public financial management; (iii) the fiscal policy challenges posed by SOEs; (iv) the use of medium-term fiscal frameworks (MTFFs), budgetary anchors, fiscal responsibility frameworks and fiscal rules; (v) the role of fiscal policy in addressing risks posed from ND&CC; (vi) the fiscal policy implications and risks arising from innovations in revenue mobilization, particularly through CBI programs; and (vii) the challenges in balancing macroeconomic and debt sustainability while promoting growth. Many of these, including tax and expenditure policy and the fiscal policy challenges posed by SOEs and fiscal policy frameworks, represent areas in which the IMF has long-standing expertise; others such as the implication of ND&CC have required the Fund to develop new skills and approaches.

19. Tax policy and revenue administration issues have comprised a large share of the Fund's overall fiscal policy engagement in SDS. For SDS, raising the revenue base and achieving greater stability in revenue flows has been critical in the face of volatility in key tax bases[5] and heavy expenditure costs associated with high civil service payrolls. Many SDS have a history of heavy reliance on external grants or on revenues from depletable natural resources and have recognized that such grants or mineral endowments may prove finite and that mobilizing revenue from domestic tax sources is necessary for fiscal resilience (see Woetzel and others, 2020). Moreover, most finance ministries have been aware of the weaknesses that characterize their customs and revenue services: inefficiencies in collections, lack of compliance, lack of buoyancy in particular revenue bases, and the foregone revenues associated with tax exemptions and incentive schemes (Kidd, 2010).

20. Over the decade, SDS sought to achieve, with Fund policy advice and support, sustainably higher tax to GDP ratios, in order to achieve primary balance targets or to achieve recognized fiscal savings objectives. As discussed later in this paper, while the Fund achieved some traction in policy advice, as improvements occurred in tax ratios in 22 of the 34 SDS, a step change has nevertheless proved elusive. In 2020, the tax ratios of 16 SDS were still under 20 percent of GDP and only 6 had revenue ratios of 25 percent of GDP or more. The average tax ratio of the 34 SDS amounted to 19.6 percent of GDP in 2010, declined slightly through 2015, and then increased to 20.5 percent in 2020.[6]

21. Expenditure policy and public financial management represented a second crucial component of Fund fiscal policy engagement in SDS. Engagement occurred through Article IV

[5] Examples include volatile revenue from South African Customs Union revenue sharing in Eswatini, fishery license fees in the Western Pacific, logging revenues in the Solomon Islands and tourism-related revenues in many industrial market-sensitive island economies.

[6] Here the caveats on data indicate the imprecision of this result. Moreover, tax collection specifically in 2020 was adversely impacted by the pandemic.

surveillance discussions and with a more intensified focus in the context of Fund programs and CD. The focus of attention centred on expenditure issues that created the greatest risks to fiscal sustainability or which needed attention to support realization of the Sustainable Development Goals. Policy advice was often supported by the provision of critical capacity building support to strengthen the effectiveness and quality of analysis of the budget process, the efficiency and discipline of public financial management (PFM), and the quality of public investment evaluation and management.

22. Development of fiscal responsibility frameworks was another important component of the Fund's fiscal policy engagement in many SDS. Beyond shorter-term challenges to revenue and expenditure management, SDS faced additional risks to fiscal stability, including due to their small economic and population size, limited institutional capacity and their vulnerability to shocks from large NDs. This also required assessment of the size of expenditure multipliers arising from fiscal interventions (see Guy and Belgrave, 2012; Gonzalez-Garcia and others, 2013; and Alichi and others, 2019). These issues were particularly germane for those SDS involved in managing the finances associated with significant natural resources or financial reserves or the receipt of significant but time-limited fiscal transfers from partner countries. Consequently, a substantive element of Fund fiscal policy engagement in SDS included efforts to strengthen the governance frameworks under which fiscal and budgetary decisions are made, encouraging these to be positioned within a medium-term budgetary framework that goes beyond simple medium-term strategies or planning processes; and setting out alternative medium-term budget and policy scenarios and frameworks within which fiscal decisions could be guided. [7] In several SDS, Fund staff emphasized the need for a formal, legislated, fiscal responsibility framework or the adoption of fiscal rules.

23. The decade beginning in 2010 marked a significant turning point in how the Fund approached the risks posed by ND&CC for SDS. The preceding decade had seen the occasional speech by IMF management and a few papers and books emphasizing the risks on the horizon.[8] But the devastating effect of a number of severe cyclones and hurricanes and the increasing weight of scientific evidence and understanding catalysed deeper awareness that many SDS were exposed to an existential threat to their populations and their economies. NDs, long a fact of life to these SDS, became more frequent and more intense in the damage caused. In turn, increased recognition of SDS' exposure to the impacts of NDs spurred a substantial escalation in Fund surveillance to mitigating and adapting to these consequences, including attention to fiscal and debt accumulation risks (see IMF, 2013b; Towe and others, 2016; IMF, 2017c; and Nakatani, 2019).

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[7] The Fund has started to mount governance missions to member countries since the adoption of the 2018 Framework for Enhanced Fund Engagement on Governance (IMF, 2018b). The recommendations of these missions on fiscal transparency and public financial management are envisaged to be incorporated in programs and surveillance missions and may help SDS identify gaps in their administrative and legal practices.

[8] Heller (2003), Speeches by the Deputy Managing Directors (Kato and Portugal) in 2007 and 2009.

24. Some SDS also innovated in their search for fiscal resiliency, notably through the development of CBI programs. Fund surveillance covered the macroeconomic, fiscal and political economy issues raised by these programs, highlighted risks, and advised country authorities to address these at an early stage in the conceptualization and development of these programs.

25. IMF engagement included regular and extensive assessments of the debt sustainability of SDS. DSAs have been an integral part of the IMF's toolkit for almost all surveillance and program-related discussions of fiscal resilience in SDS. DSAs have provided a standardized assessment and quantification of risks arising from a country's outstanding and likely future public debt and debt service, based on two alterative tools—the DSA for market access countries and the DSA for low-income countries (LICs). These DSAs examined multiple factors that contribute to the potential accumulation or reduction of debt, including for example the projected primary fiscal balance over the medium term and the extent of non-concessional financing. They reflect staff's understanding of the present and future fiscal policy framework, including the policy measures that the authorities have programmed to put in place; and require an awareness of the magnitude of likely domestic and external shocks that can affect key fiscal and other macroeconomic variables. As noted earlier, for particular SDS, these could include the risk of frequent (occasionally catastrophic) NDs, fluctuations in tourism revenue from partner countries, shifts in commodity prices for their natural resource exports, or climate-induced effects on the stock of fishery reserves.

26. While this section has emphasized common challenges for IMF fiscal engagement with SDS, IMF engagement was also specifically tailored to take account of particular predominant economic and structural features that some SDS share for fiscal policy management, and which have led to some specific challenges shared among smaller sub-groups of SDS (Table 1). These subgroups comprise: (i) the largely tourism-based members in the Caribbean, Africa, the Indian Ocean and the Western Pacific, including 17 SDS, or half of all SDS; (ii) the 7 SDS whose fiscal situation was highly dependent on their natural resource endowments; (iii) the 6 small microstate SDS of the western Pacific (labelled as the "compact countries"), beneficiaries of a significant but limited financial asset legacy that will no longer be available from the mid-2020s; and (iv) the 4 SDS with similar economic characteristics to tourism-dependent SDS but which encountered significant structural and political difficulties in pursuing adjustment policies in concert with the IMF during the evaluation period (and labelled as "adjustment challenged"). In the remainder of the paper, Fund engagement with these four subgroups of SDS is regularly referenced, highlighting how Fund engagement was calibrated to address their specific fiscal policy challenges.

IV. POLICY ADVICE AND SURVEILLANCE

27. This section evaluates the coverage, quality and timeliness of fiscal policy advice in the context of IMF surveillance with SDS during the evaluation period. The section first assesses overall coverage of fiscal policy issues in SDS; and then evaluates coverage of selected fiscal policy issues, particularly those where the conduct of fiscal policy in SDS called for unique, new or innovative forms of policy advice.

Table 1. Differentiating SDS by their Principal Fiscal Characteristics and Policy Challenges

SDS sub-groups	Key characteristics	Fiscal policy emphasis
Tourism-based SDS (17): The Bahamas, Barbados, Belize, Cabo Verde, Dominica, Fiji, Grenada, Maldives, Mauritius, Montenegro, Samoa, Seychelles, St. Kitts and Nevis, St. Lucia, St. Vincent and the Grenadines, Tonga, and Vanuatu.	Tourism-based economies, limited diversity outside principal export sector, absence of natural resource endowment, highly sensitive to competitive market pressures, vulnerable to ND&CC, large-scale impact from the COVID-19 pandemic	Foster fiscal resilience and sustainability; Address debt sustainability; Foster Economic Growth; Reduce fiscal dependence on limited number of productive sectors; Promote equity; Address risks associated with ND&CC.
Natural Resource-based SDS (7): Bhutan, Djibouti, Guyana, Solomon Islands, Suriname, Democratic Timor-Leste and Trinidad and Tobago.	Significant actual or potential natural resource endowment or strategic location, with fiscal policy heavily reliant on royalty revenues, with reserves limited or exhaustible; lack of economic diversity; sustainability issues due to high infrastructure costs and debt incurred in accessing resources; volatility in natural endowment prices.	Foster fiscal resilience and sustainability; Address balance in inter-generational fiscal policy management of natural resource endowment; and sovereign wealth funds developing and managing institutional frameworks (Trust Funds); Address risks associated with CC; Promote equity; Reduce fiscal dependence on limited number of productive sectors, particularly given finite nature of natural resource endowment.
"Fiscal Compact" micro SDS of the Western Pacific (6): Kiribati, Marshall Islands, Micronesia, Nauru, Palau, Tuvalu.	Presence of significant financial asset legacy, from previous (now exhausted) natural endowment, or initial or continuing financial grant. Exceptionally small, undiversified economic base; highly vulnerable to ND&CC.	Management of legacy; generation of income stream from legacy savings; planning for termination of future grants; Foster fiscal resilience and sustainability in the face of volatile revenue base, threats from ND&CC; Use infrastructural investment policy both to adapt to CC and facilitate some economic diversification.
"Adjustment Challenged" SDS (4): Antigua and Barbuda; Comoros, Eswatini, and São Tomé and Principe.	Limited recourse to financial reserves, capital markets or natural resource assets; previous challenges related to limited institutional capacity, weak governance and political instability; Adjustment efforts with IMF have proven unsustainable due to weak institutions and political economy; particular volatility from discrete revenue sources including vulnerability to exogenous shocks, and ND&CC.	Pursue sustained fiscal policy dialogue; provide TA to incrementally strengthen fiscal and macroeconomic policy management, revenue administration, tax policy regime, and public expenditure management. Seek to gradually foster fiscal resilience and sustainability

Source: SDS Article IV Consultation Staff Reports, 2010–2020.

A. Overall Coverage

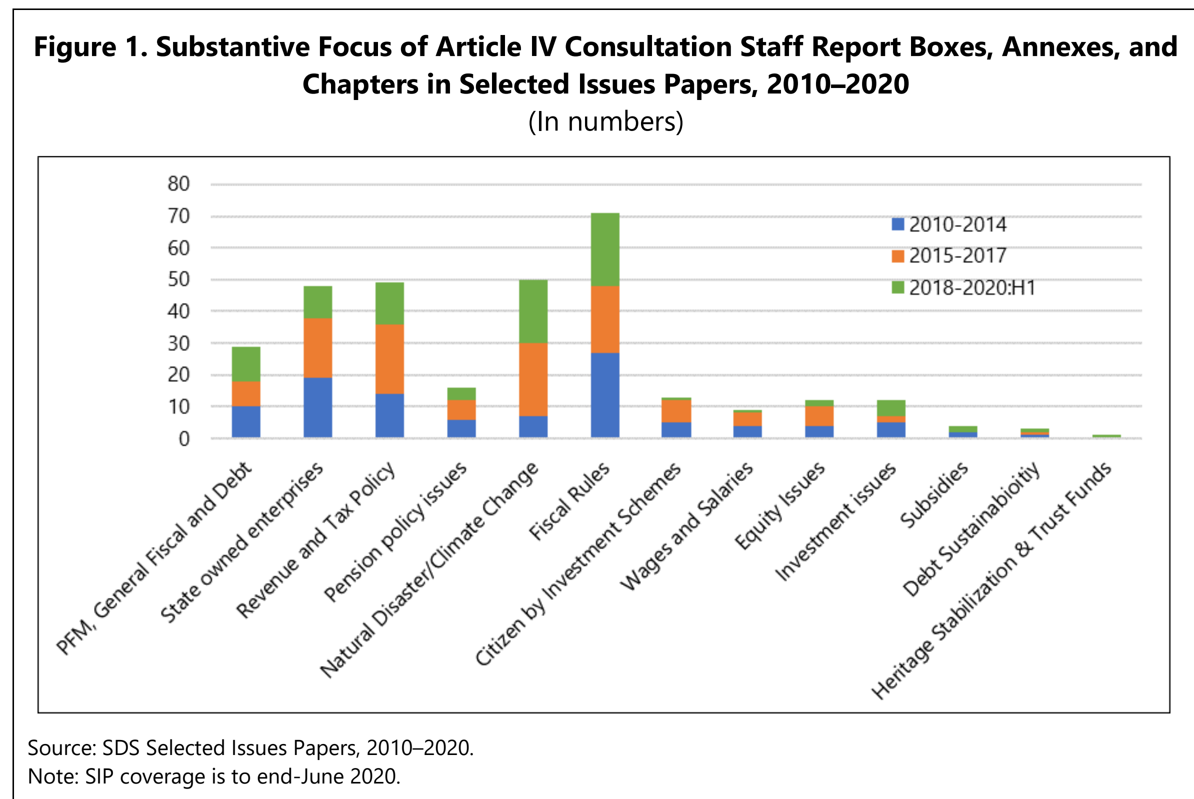
28. An analysis of text boxes, Article IV consultation staff report annexes, and chapters in SIPs prepared for the Executive Board (Figure 1) provides an indication of the intensity of analysis and the relative balance of Fund engagement across different fiscal policy topics over the evaluation period. Of 317 boxes, annexes and SIP chapters in Article IV consultation staff reports and SIP chapters related to fiscal policy, 22 percent discussed topics related to the strengthening of the framework of fiscal policy management, including discussions of fiscal rules, fiscal responsibility legislation, and fiscal multipliers, and debt sustainability. Three topics each commanded roughly

one-sixth of these focused discussions: ND&CC (16 percent); tax policy (15 percent); and issues relating to SOEs and public-private partnerships (15 percent). Other areas receiving notable attention included CBI programs, wages and salaries, public investment, pension policy, and public financial management.

29. As shown in Figure 1, the number of these special features has increased markedly. Notably, 67 percent of the boxes and annexes were associated with the second half of the evaluation period 2015–2020. Even more striking, 87 percent of the boxes and annexes dealing with ND&CC were in this latter period, as were 70 percent of the boxes and annexes dealing with tax policy, reflecting clear staff uptake of the 2014 and 2017 SGNs.

Figure 1. Substantive Focus of Article IV Consultation Staff Report Boxes, Annexes, and Chapters in Selected Issues Papers, 2010–2020

(In numbers)



Source: SDS Selected Issues Papers, 2010–2020.
Note: SIP coverage is to end-June 2020.

30. The Fund's coverage of fiscal policy issues has closely matched the specific fiscal policy challenges identified in the four SDS groupings discussed above, signalling that coverage was attentive to the country-specific challenges faced by SDS. For example, in the period following issuance of the 2017 SGN, 65 percent of analyses of ND&CC impacts related to tourism-based SDS and another 21 percent related to the six western Pacific Compact SDS, where ND&CC challenges are most stark. On topics related to the management of macro fiscal policy (including fiscal anchors, fiscal rules and fiscal responsibility legislation), SDS with significant natural resource endowments were the focus of 37 percent of the macro fiscal boxes, annexes and SIP chapters, with 73 percent of these issued after 2014. In contrast, only 52 percent of boxes, annexes and SIP chapters for the Pacific Compact SDS were issued in the second half of the decade, perhaps reflecting early awareness of the looming 2024 fiscal cliff associated with the

cessation of grants from their principal donor patron countries. Also, the half-decade period after the 2014 SGN saw 61 percent of Article IV consultation staff report boxes and annexes relating to other fiscal issues encountered by the Compact SDS (tax policy and revenue administration, public financial management, current expenditure and investment policy, and SOE issues).

B. Tax Policy and Revenue

31. A review of Article IV consultation staff reports of all 34 SDS over 2010–2020 illustrates considerable attention to the revenue policy challenges facing SDS, but overall, progress in achieving tax reform was mixed. There were a few notable examples of significant progress in advancing tax reform broadly in line with IMF policy advice in staff reports. A value added tax (VAT) was introduced in a number of countries during the period (e.g., in St. Lucia, 2012; Eswatini, 2012; Fiji, 2010; Grenada, 2010; Kiribati, 2014; and Seychelles, 2013), or streamlined in Cabo Verde (2014) and Guyana (2017). Fiji, Maldives and Samoa in particular realized significant strengthening of their revenue performance and instituted reform initiatives. Mauritius pursued innovative tax reforms, including introduction of a Green tax in 2008 and a broadening of its VAT base. It also addressed more complex tax policy issues associated with its efforts to become a regional financial centre. In regard to revenue administration, Article IV consultation staff reports for 23 of 34 SDS pointed to persistent and serious ongoing challenges. For six SDS, however, staff reports underscored that significant progress had been made in enhancing revenue administration over the decade.[9]

32. On specific tax policy issues, including advice on reducing or eliminating exemptions or questionable tax incentives, staff advice was often reiterated in surveillance throughout the decade, but with only minor progress achieved in actual policy changes. Article IV consultation staff reports emphasized these issues at the beginning of the decade in more than two-thirds of SDS, while a review of staff reports at the end of the decade showed that at least some progress has occurred in six countries (Belize, Fiji, Guyana, Maldives, Samoa, and Seychelles).

33. Experience over the evaluation period shows a number of challenges to achieving traction in Fund policy advice on tax reform. It is relatively straightforward to provide advice highlighting the amount of taxes forgone by particular tax provisions, often equivalent to several percent of GDP in additional revenue. Several Article IV consultation staff reports provided quantitative estimates of revenues foregone, as a share of GDP, from tax incentives or exemptions.[10] However gaining the political support to enact legislation can be very difficult, particularly given the political and economic power of those whose incomes or consumption are most at risk. In some cases, lack of political will, weak internal coordination between Ministries of

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[9] SDS identified as having made the most significant progress in revenue administration include Maldives, Samoa, Fiji, St. Lucia, Micronesia, and Guyana.

[10] These are noted for Antigua and Barbuda (AIV 2017) (4 percent), Bhutan (SIP 2014) (3 percent), Djibouti (AIV (2016) (7 percent), St. Kitts and Nevis (AIV 2017) (6 percent), and St. Vincent and the Grenadines (AIV 2016) (4.8 percent).

Finance and Line Ministries, as well as administrative capacity constraints impeded progress. Moreover, even with a political mandate, tax reform takes time—often as much as a decade—including to enact legislation, put in place the administrative machinery for collection of revenues or to foster compliance by taxpayers.[11] Often, significant tax reforms occurred over several years. Article IV consultation staff reports over the decade illustrate that a number of SDS that implemented a VAT either before or soon after 2010, pursued a significant subsequent reform agenda over several years.

34. While direct evidence of traction in policy advice and revenue administration strengthening is mixed, trends in tax revenue shares in GDP over the entire decade suggest that the majority of SDS did make progress towards stronger revenue mobilization.[12] As noted earlier, some 22 members—almost two-thirds of SDS—achieved an improvement in their tax-to-GDP ratios over the decade, often by a significant magnitude, e.g., Barbados (2.8 percent of GDP), Belize (5.5), Grenada (3.2), Fiji (2.4), Maldives (3.0), Tonga (3.2), Cabo Verde (2.8), Seychelles (2.1), Micronesia (5), Nauru (13), Guyana (2.6), Montenegro (2.0) and Timor-Leste (for the latter, the non-oil tax share in non-oil GDP increased from 1.2 percent to 4.8 percent of GDP). For countries seeking to find fiscal space, such changes are not trivial, especially for countries whose revenue shares were relatively low at the beginning of the decade (such as Grenada, Maldives, Tonga, Cabo Verde, Marshall Islands, Micronesia, and Nauru (e.g., under 20 percent of GDP).

C. Expenditure Policy and Public Financial Management

35. Two issues dominated Fund fiscal engagement with SDS on expenditure policy in both surveillance and program support: containing and reducing the share of the budget on wages and salaries and addressing the need for productive, well-maintained capital expenditure. While the issue was most intense in the context of Fund-supported programs (particularly for Grenada and St. Kitts and Nevis in the Caribbean and the Union of the Comoros and Eswatini in Africa), this was only narrowly more than for SDS engaged only in surveillance discussions (Figure 2). The importance of the issue is not surprising, given that wages and salaries often absorb nearly half of total government spending, with further costs implied in later years in pension outlays. Only for non-program surveillance discussions in natural resource-based SDS does the issue receive somewhat less attention (but still occurring in three-quarters of these SDS). Typically, the staff worked with the authorities to implement various approaches common to all countries (not only in SDS), e.g., a wage freeze over several years, reliance on attrition in filling posts, cutbacks in filling vacancies, and occasionally salary cutbacks. However, such measures tend not work well without a comprehensive public sector strategy on the wage bill.

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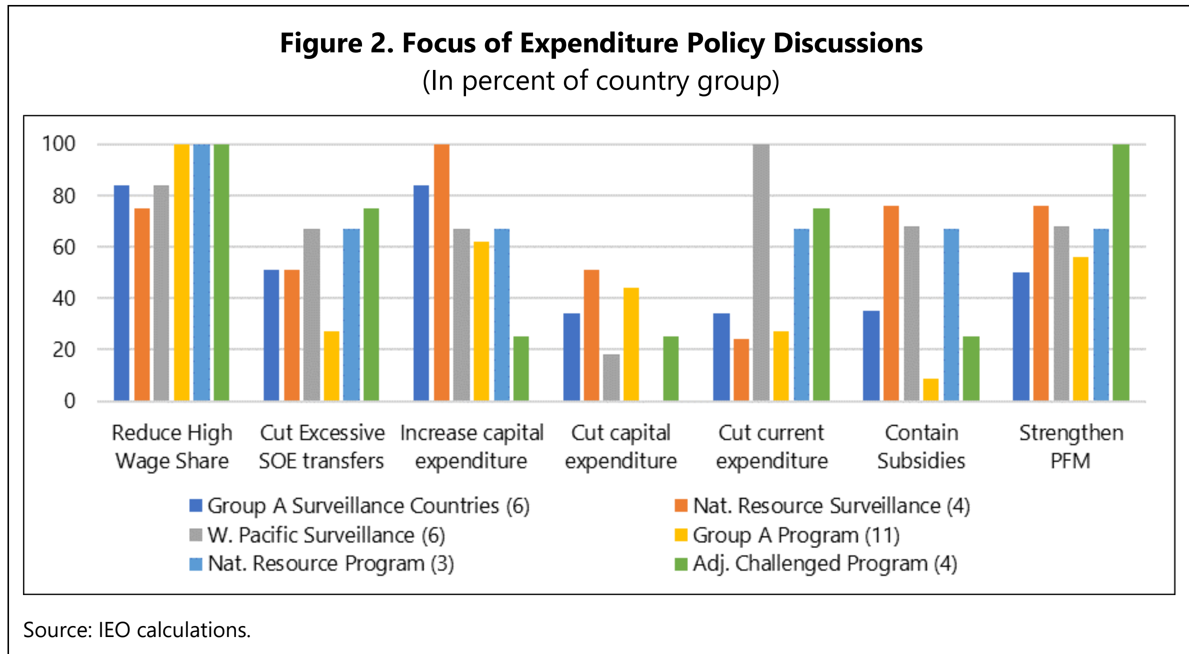
[11] For example, the timetable of Suriname to introduce a VAT was delayed from end-2013 to 2022 (most recently).

[12] The Fund’s contribution reflects the synergistic effects of surveillance-induced advice on tax policy reform, reinforced by the role of CD in pursuing the associated required administration changes needed to implement such reforms and the institutional strengthening required for ongoing revenue and tax institutions.

Figure 2. Focus of Expenditure Policy Discussions
(In percent of country group)



Source: IEO calculations.

36. Progress in containing public wage shares was uneven. The government wage share in GDP was significantly reduced, with notable successes in The Bahamas, Grenada, St. Lucia, Maldives, Cabo Verde, the Comoros, Eswatini, and Kiribati. Conversely, however, the wage share in GDP rose in several SDS during the decade, including in St. Vincent and the Grenadines, Seychelles, Mauritius, São Tomé and Principe, Guyana, Trinidad and Tobago, Palau, Suriname, and Micronesia.

37. The focus on capital expenditure proved more complex. With the exception of the adjustment-challenged SDS, Fund staff supported an *increase* in the share of the budget allocated to *productive* capital expenditures in roughly two-thirds of the SDS, particularly among the small island states of the Pacific and the Caribbean, many in the context of Fund-supported programs. The growth objective was clearly a priority in this context. Particularly later in the decade, Fund staff supported spending on climate-resilient infrastructural investment and a focus on upgrading reconstruction expenditure on resilience (in the wake of NDs). This bias was accompanied both by an emphasis on containing or reducing the share of the budget on non-essential current expenditures (i.e., not health and education spending) as well as on non-priority capital expenditures. In a few cases, Fund staff argued for adjusting the composition of the capital expenditure budget. In small island economies, excepting those in the Pacific compact states, the Fund staff advocated cuts in non-priority capital and current expenditure in half of the countries while also supporting an increase in other forms of capital expenditure in the budget, particularly climate resilient infrastructure. In recent consultations particularly, Fund staff have emphasized budgeting for operations and maintenance of infrastructure, particularly that related to climate resilience.

38. The emphasis on containing current expenditure not only related to containing outlays on wages and salaries, but also centred on two other sources of expenditure "leakage," viz., commodity subsidies and persistent transfers to public entities (largely non-financial SOEs) providing public services or operating with significant losses (such as in the case of state-owned airlines). Arguments for cuts in transfers to SOEs appeared frequently—in more than 50 percent of surveillance discussions in the tourism-based SDS, though less in Fund-supported programs with this group. The frequency is even higher for natural resource-based SDS and compact states. Frequent emphasis on "targeting" appeared in Fund staff advice, recognizing that while the purpose of subsidized commodities or public utility provision has a well-intentioned distributional objective, the amount of leakage to non-poor and non-vulnerable groups is substantial, raising questions as to the value of the spending relative to other policy priorities. Fund and World Bank staff have well-developed approaches as to how targeting can be strengthened, but the Fund staff tended to rely on partner institutions to assist in the reforms of such programs. Containing consumer subsidies by targeting was supported in roughly half of the tourism-based SDS and in most of the natural resource-based SDS.

39. Finally, the Fund paid attention to a common longer-term challenge confronting SDS, viz., the financial weakness of the pension schemes for government employees. The issue was particularly prevalent among the tourism-based Caribbean SDS, with detailed boxes or annexes analyzing the issue and providing concrete policy recommendations in half of these SDS, with the issue particularly emphasized during 2010–2017, often repeatedly.[13] Actuarial assessments carried out in due diligence reports by government auditors often revealed schemes being seriously underfunded, with the present value of unfunded liabilities reaching over 10 percent of GDP (e.g., in Grenada and Palau). In some case, pension reserves were already exhausted (e.g., in Antigua and Barbuda) or will be not too far in the future (e.g., in the Marshall Islands). In budget-financed systems, expenditures on pensions and retirement benefits absorbed 3 percent of GDP in St. Vincent and the Grenadines during 2014–2017. In general, staff characterized the pension schemes as needing significant parametric reforms to restore financial sustainability (requiring upward adjustment in the retirement age, reduction in the maximum pension, and increased contribution rates). Within the DSA framework, staff also emphasized the need for these weaknesses to be highlighted in both Risk Assessment Matrices (RAMs) and reflected as contingent liabilities. The reports suggest that authorities were responsive to staff recommendations, though the reforms were usually seen as requiring further initiatives (e.g., in Mauritius, Palau, Marshall Islands, St. Lucia, and Suriname).

[13] Within this group, the issue was of particular concern in the Caribbean (specifically in The Bahamas, Barbados, Belize, Dominica, Grenada, St. Kitts and Nevis, St. Lucia, and St. Vincent and the Grenadines); it also emerged in Mauritius, the Seychelles and Cabo Verde. In other SDS groups, it also arose in Antigua and Barbuda, Suriname, Trinidad, Marshall Islands, and Palau.

D. Fiscal Policy Frameworks

40. Over the course of the evaluation period, staff sought to anchor efforts at fiscal consolidation in SDS—typically to encourage a downward trajectory over time in the public sector's debt-to-GDP ratio—by identifying key aggregate targets for fiscal policy sustainability. Traction in policy advice proved slow in the early period of the evaluation. The 2014 SGN, however, sought to instil new momentum. The SGN pointed to empirical evidence suggesting that fiscal consolidation in SDS had been more successful when fiscal rules were present. But it recognized that the challenges for the design and operation of fiscal rules were particularly acute for small states and that few had adopted such rules to date. It provided guidance on approaches that could be tailored to SDS needs (Appendix Box 1, 2014 SGN).

41. The 2014 SGN clearly had a galvanizing impact, triggering both an intensification of staff policy advice and significant progress in achieving traction with SDS authorities. First, in two-thirds of SDS in post-2014 Article IV consultation staff reports, the Fund urged countries to tether their fiscal policy frameworks to a policy anchor—typically, a public debt-to-GDP ratio—within an MTFF (Table 2).

42. While no more than 10 percent of countries adopted such a framework before 2014, about a third did so in the following five years, with half adopting an anchor (relative to a third prior to 2014). Second, Fund staff significantly increased its advocacy for the adoption of fiscal rules within a fiscal responsibility framework—the share of SDS receiving this advice rose from about 40 percent of countries pre-2014 to about 70 percent thereafter. The number of countries implementing such a rules-based framework doubled from only three to seven, showing slow but significant progress from this increased attention.

43. Notwithstanding this progress, country interviews, particularly for Pacific SDS, suggest that stronger staff follow-up could have fostered more consistent advances. First, advice could have offered greater specificity of comprehensive fiscal rules that can address potential slippages taking account of country circumstances. Second, staff could have devoted more attention to working with countries to facilitate their implementation, including with CD.

E. Fiscal Policy, Natural Disasters, and Climate Change

44. The 2014 SGN underscored the challenges to achieving economic resilience in the face of ND&CC risks and marked a clear turning point in the intensity of Fund surveillance on these issues. It recognized that macroeconomic resilience would typically require adequate fiscal and external buffers to weather shocks. Fiscal instruments were recognized as key elements in any response. With most SDS already at risk of debt unsustainability in the aftermath of the global financial crisis, a fiscal role in seeking resilience to NDs necessarily had to be shoehorned into the fiscal consolidation strategy of many SDS. Before 2015, the issue of NDs had appeared in only seven boxes or annexes in SDS Article IV consultation staff reports. By mid-2020, there were 45 such pointed discussions on the issues associated with a fiscal response to NDs for the 25 SDS

where such disasters were deemed likely (also see staff research including Lee and others, 2018; Nishizawa and others, 2019; Cantelmo, 2019; and Cevik and Nanda, 2020).[14] Outside of the formal consultation process, the Fund also conducted a Climate Change Policy Assessment (CCPA) addressing both adaptation and mitigation issues in Belize (2018), St. Lucia (2018), Grenada (2019), Seychelles (2017), Micronesia (2019), and Tonga (2020).

Table 2. Efforts of Staff to Strengthen the Macro-Fiscal Policy Framework

	2010–2014	2015–2019
Medium-term fiscal framework	The Bahamas, Barbados, Belize, **Dominica,** St. Kitts and Nevis, St. Lucia, St. Vincent and the Grenadines, Fiji, Maldives, Tonga, Cabo Verde, **Mauritius,** Seychelles, Antigua and Barbuda, Comoros, Eswatini, São Tomé and Principe, Suriname, Trinidad and Tobago, Timor-Leste, Kiribati, Micronesia, Tuvalu	**The Bahamas,** Barbados, Belize, **Dominica,** Grenada, St. Kitts and Nevis, St. Lucia, St. Vincent and the Grenadines, **Fiji, Samoa,** Tonga, Vanuatu, **Cabo Verde, Mauritius, Seychelles,** São Tomé and Principe, Suriname, **Guyana,** Trinidad and Tobago, Timor-Leste, Djibouti, Kiribati, Palau
Adoption of an anchor (in most cases a debt target); except in Tonga (targeting the operating cash balance) and Cabo Verde (the primary balance)	The Bahamas, Barbados, **Belize, Dominica, St. Kitts and Nevis,** St. Lucia, **St. Vincent and the Grenadines, Fiji, Maldives, Samoa, Tonga, Mauritius, Seychelles,** Antigua and Barbuda, Eswatini, São Tomé and Principe, Timor-Leste, Suriname, Guyana, **Bhutan,** Solomon Islands, Tuvalu	The Bahamas, **Barbados (9), Belize (9), Dominica, Grenada, St. Kitts and Nevis, St. Vincent and the Grenadines, Fiji, Maldives, Samoa, Tonga, Vanuatu, Cabo Verde, Mauritius, Seychelles, Antigua and Barbuda,** Timor-Leste, Guyana, Solomon Islands, Djibouti, Kiribati, Palau
Fiscal rules and fiscal responsibility framework	The Bahamas, Barbados, Belize, St. Lucia, **Maldives,* Mauritius,** Antigua and Barbuda, Eswatini, Bhutan, Solomon Islands, Timor-Leste, Micronesia, Tuvalu	The Bahamas (6, 7, 8), Barbados (10), Belize, Dominica, **Grenada,*** St. Kitts and Nevis, St. Lucia, **Maldives,*** Samoa, Tonga, Vanuatu, **Mauritius,** Eswatini, Suriname, **Guyana,** Trinidad and Tobago, Bhutan, Solomon Islands, Timor-Leste, Djibouti, Kiribati (1), Marshall Islands, **Nauru (2), Palau (3, 4),** Tuvalu (5)
Codes for other observed operational targets		
Domestic recurrent balance (1)		
	Current fiscal balance (3)	Permanent ceiling on the deficit (6)
Non-Refugee Processing Center current balance (Nauru) (2)	Balanced or surplus cash flow (4)	Cap on current expenditure growth (7)
Use of fiscal rules (9)	Structural balance Target (5)	Exceptional circumstances (8)

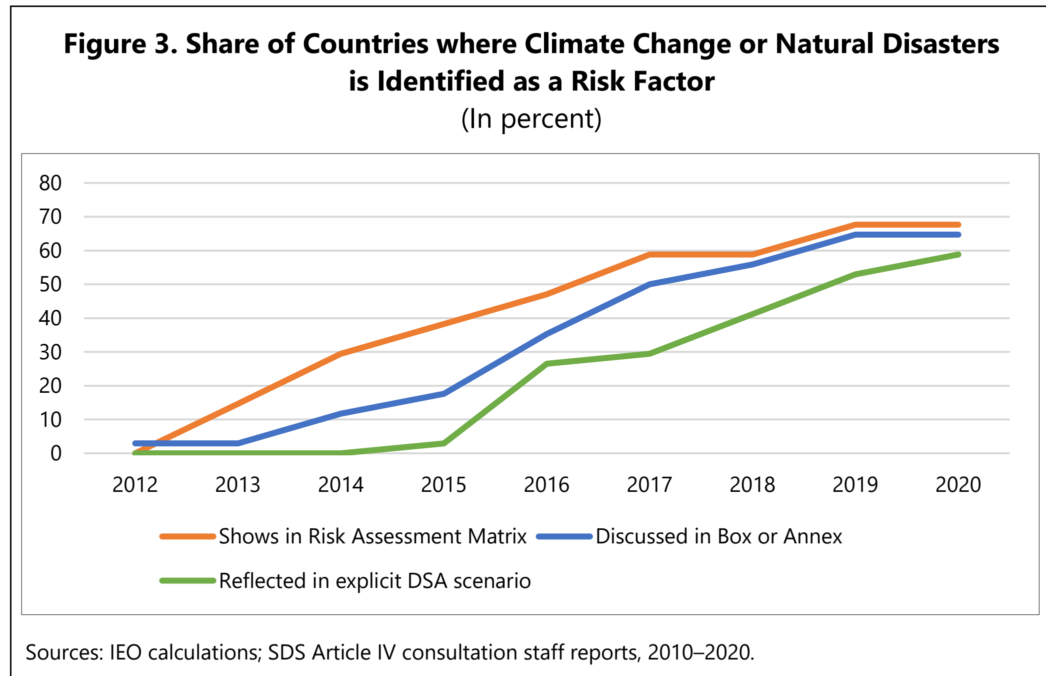
Sources: Author's calculations; SDS Article IV consultation staff reports (2010–2020).
Notes: Nonbold: countries where IMF staff proposed a strengthening in the macro-fiscal policy framework. Bold: countries that have actually introduced a strengthening of the macro-fiscal policy framework. Asterisk: countries where a fiscal responsibility framework has been put in place.

[14] Attention to ND&CC risks featured prominently, for example, in AIVs for Antigua and Barbuda (2017), Barbados (2019), Fiji (2018 and 2019), Maldives (2016), St. Lucia (2018), St. Vincent and the Grenadines (2014 and 2018), Samoa (2015), Seychelles (2017 and 2019), Tonga (2016 and 2017), and Vanuatu (2015, 2016, 2018, and 2019).

45. Similarly, attention to the risks and consequences of NDs, signalled in the RAM in a number of IMF surveillance reports (see Figure 3), escalated over the decade. Prior to the 2014 SGN, these risks were identified in a few Caribbean and Pacific SDS, notably Dominica, Antigua and Barbuda, Fiji, and Vanuatu, all in 2013. By 2014, such risks were highlighted in the RAM of Grenada, St. Vincent and the Grenadines, the Union of the Comoros, Marshall Islands, Palau, and Tuvalu. By 2016, nine more RAMs of SDS flagged the concern, and others soon followed. By 2020, the RAMs for only seven SDS did not flag this as a relevant risk for macroeconomic policy concern.[15]

Figure 3. Share of Countries where Climate Change or Natural Disasters is Identified as a Risk Factor

(In percent)



Sources: IEO calculations; SDS Article IV consultation staff reports, 2010–2020.

46. Both the content and complexity of Fund surveillance and policy advice on ND&CC issues broadened over the evaluation period. Initially, staff offered two forms of advice: to build financial buffers by aiming a country's fiscal policy targets (viz., its primary budget surplus) to bring the debt-to-GDP ratio below the country's previous target level, thereby providing additional capacity to use debt to finance relief and reconstruction costs; and to increase the resilience of infrastructure to NDs, by upgrading existing infrastructure to be able to withstand the effects of a storm of "normal" intensity, based on the historical frequency of most storms—though not the most catastrophic—experienced by the country in the past.

47. Over time, surveillance discussions increasingly emphasized the risks posed by the occurrence of NDs and likely costs. These included ex ante initiatives to strengthen the resilience of exposed infrastructure and proactive disaster management strategizing; a strengthening of

[15] The economic challenges posed by climate change for these remaining SDS were likely of a kind less dramatic than a hurricane. For example, a landlocked country, such as Eswatini, has faced the challenge of severe drought during the period (as has Djibouti).

building codes and regulatory provisions; and preparing for the financing of both the ex post costs of relief and support to affected population groups in the event of a disaster and of the potential costs of reconstruction to damaged public infrastructure and buildings (and possibly in support of private assets).[16] To quantify the need for fiscal space, it thus became important to understand how frequently a country would likely be exposed in the future to such events, and their likely scale of damage.[17] Both staff and countries recognized that fiscal space could and should be created to finance the costs of frequent but low-damage events; and that for events with low frequency but high or catastrophic damage, international financial support would most likely be needed (IMF, 2017a).

48. As the decade evolved, staff discussions in many SDS, particularly in the Pacific Island states, broadened further to recognize that these NDs had to be seen as a reflection of the increasing intensification of CC forces. In addition to the costs associated with preparing and dealing with sudden ND shocks (often termed as "cyclical" events), one had to also create fiscal space to finance adapting to the "structural" effects of CC on the economy, the environment (particularly coastal zones) and population settlements.[18] This meant more proactive assessment of CC effects arising from changes in temperature or precipitation patterns, sea level rise, ocean quality (with effects on coral bleaching or the state of the marine fisheries), and the potential for fires.[19] This also involved clarifying the extent to which adaptation efforts would require public rather than private sector involvement. Having recognized the need for additional fiscal space, policy challenges were focused on two issues: how to create additional fiscal space, given ongoing challenges to fiscal consolidation; and how to ensure its institutional sufficiency and availability (IMF, 2018d). This meant an intensified focus on enhancing the primary budget balance, necessitating, inter alia, expenditure rationalization, revenue mobilization and better control of SOEs (see Section IV below). This approach was adopted, for example, for the Seychelles, which benefitted from being the first Fund member to carry out a joint IMF-World

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[16] In some cases, staff also underscored the costs of maintenance of the strengthened infrastructure.

[17] Staff reports suggest a reliance on various academic or UN sources for estimates of the likely frequency of ND events, including the al disasters database, the Global Climate Risk Index from German Watch and the United Nations University—Institute for Environment and Human Security. More recently, the ESRI.com global model from the Mora Lab could be used to enable projections of the various impacts of climate change at a country level, looking forward through the century under alternative scenarios for global mitigation efforts.

[18] In the Marshall Islands (AIV 2016), the ADB estimated the "structural" component at 2.5 percent per year, related to the cost of preparing for climate change; the "cyclical component"—10 percent of GDP over 20 years—relates to the disaster-related losses and damages that could occur once every 20 years in the Marshall Islands.

[19] As an illustration, for Antigua and Barbuda in the AIV 2017, the staff stressed the need for an adaptation strategy to articulate priority investments to strengthen resilience for critical infrastructure, water supply, and land use (including coasts) and food security. Similarly, in Djibouti—not an island state—the staff emphasized the annual fiscal space needed to "address climate-related macroeconomic vulnerabilities and promote disaster resilient infrastructure, transport and energy generation, public health capacity, risk-informed spatial planning, building standards and payment systems" (Kireyev, 2018). In countries such as Tuvalu or Kiribati, changes in weather patterns affecting the frequency of La Niña and El Niño, are expected to contribute to significant variability in fishing license fees reflecting the movement of the tuna stock.

Bank CCPA in 2017. Seychelles then adopted a two-part strategy seeking both to realize a primary surplus through expenditure rationalization and tax policy, while also finding room to move forward with a major infrastructural program to enhance resilience.

49. The quality of Fund surveillance in assessing the impact of NDs in SDS deepened further in 2016, with the staff paper on Small States' Resilience to Natural Disasters and Climate Change (IMF, 2016). This paper specifically required that for SDS prone to NDs, ND&CC shocks should be embodied in the DSA exercise. This could take the form of assuming a reduced longer-term real growth rate, a debt-creating flow of a specified percentage of GDP per year to account for reconstruction following NDs and/or a higher allowable external debt ratio. For many SDS, one could also include additional downside-specific stress tests for NDs, sometimes joined with the effect of contingent liability shocks (e.g., related to losses or debts of SOEs).[20] Such assessments would highlight how much debt ratios could be thrown off track as a consequence of NDs, leading to a higher likelihood of a debt distress rating. The DSA in such cases typically highlighted the scale of the financial buffer that would be needed to cope with unexpected events and thus the scale of the additional fiscal consolidation required for debt sustainability.

50. In the second half of the evaluation period, motivated by the 2014 SGN and the 2016 staff paper, the Fund deepened and tailored its policy advice to SDS. Surveillance reports from 2015 began to detail extensive staff efforts to identify and propose the most appropriate approach to achieve the additional fiscal space necessary to address ND&CC risks. Advice varied widely, as staff sought to tailor advice to specific country challenges. In some SDS, staff advocated a higher share of the budget to be designated for contingencies, enabling ready cash to be available in the event of an ND. In the Solomon Islands[21] and some of the Western Pacific small compact states with more limited options for accessing capital markets, staff recommended that cash balances be targeted as a designated share of government current expenditure. In Marshall Islands and Tuvalu, staff proposed incorporating structural adaptation spending directly in budget allocations to specific ministries; and some staff argued that the investment budget should be reallocated to include additional spending on the construction or maintenance of climate-resilient infrastructural investment. Grenada and Barbados sought to realize reduced debt service in the event of a ND by introducing hurricane clauses that provided for such an adjustment in a contingency clause in their recent debt restructuring. In a number of other SDS, including Belize, Dominica, St. Lucia,

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[20] In Dominica, in 2016, in the context of its Fund-supported RCF program, the staff effectively treated the future costs of disaster-related public spending as a public contingent liability that should be integrated in the budgetary framework. Staff noted that if the fiscal consolidation plan were fully implemented, the debt outlook would improve significantly. This consolidation includes a provision of 1.5 percent of GDP per year to lower debt and to build buffers to address future NDs, providing a degree of resilience to the fiscal consolidation strategy. However, if the authorities did not undertake any additional fiscal consolidation measures, public debt would be on an upward trajectory and become unsustainable—reaching 130 percent of GDP by 2030. In the Solomon Islands in 2016, a similar type of DSA, the staff emphasized that a serious disaster would lead to initial serious losses in GDP, reduced subsequent real growth, and an increase in external public debt.

[21] In the 2018 AIV, given the frequent incidence of NDs, the staff urged the Solomon Islands to consider a contingency of 3 percent of total spending.

Kiribati, and Solomon Islands, staff argued that a designated share of the budget should be allocated explicitly to a ND savings or reserve fund, with the annual share (often as a percent of GDP) calibrated to equal the average annual cost of a ND as experienced by the country (for relief and reconstruction).[22]

51. Toward the end of the evaluation period, the Fund developed a more fine-tuned conceptual approach to building resilience in developing countries vulnerable to large national disasters (IMF, 2019). This approach proposed a new three-pillar strategy to address disaster risk management, including building structural resilience (through infrastructure, financial resilience through fiscal buffers and pre-arranged financial instruments to protect fiscal sustainability and manage recovery costs); and post-disaster resilience, including contingency planning and related investments to ensure post-disaster recovery (Cebotari and Youssef, 2020). Such an approach would have important implications for the content of surveillance and pro-growth policy advice in SDS fiscal and budgetary policy.

52. In interviews, senior staff noted that CCPAs have enabled the Fund to provide a more, forward-looking approach to thinking about economic policy, given the normally shorter-term perspective of Fund staff work. One emphasized that CCPAs can facilitate surveillance, laying the groundwork in SDS for more extensive discussions within government for thinking about how to achieve greater resilience to ND&CC risks. RCDC staff noted that in the Pacific, RCDC credibility in the PFM and budget area enhanced the Fund's input on budgeting on CC issues. But other staff questioned whether CCPAs will be effective in changing the behaviour or incentives of finance ministers. One senior staff member emphasized the weak incentives for financially strapped SDS to adopt ex ante budgetary investments in resilience to ND&CC, given that development partners are likely to provide financial support in the aftermath of a crisis.

53. Traction in Fund policy advice has been mixed. Evidence from Article IV consultation staff reports show that only limited progress occurred in concretizing the linkage between funds accrued as designated shares of the budget (some of which are sovereign wealth funds), and the specific conditions under which such funds could be allocated in relation to the occurrence of a NDs.[23] Indeed, in Kiribati, staff emphasized that its Revenue Equalization Reserve Fund should only be a last resource revenue measure in the event of an ND and financing should principally come from annual budgetary contributions.

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[22] For example, in Dominica, staff recommended annual contributions of 1½ percent of GDP to a disaster resilience fund, building up to a savings fund of 12 percent of GDP. In Kiribati (2017), staff called for an "explicit provision of up to 3 percent of GDP annually to cover the recurrent cost of coastal protection, soil desalinization, and infrastructure investment," with this amount creating a cash reserve buffer as a contingency plan to enhance ex-ante readiness to respond to NDs. In St. Lucia (2017), staff estimated the annual cost to the government at 0.8 percent of GDP but as high as 1.4 percent, both amounts exceeding current contributions of 0.5 percent of revenues.

[23] Grenada's Hurricane Contingency Fund and six funds in the Pacific are exceptions in this regard (Nishizawa, 2019).

54. Documenting the Fund's work on these issues, exposes one point of concern: over the decade. There were seven SDS—Bhutan, Djibouti, Guyana, Mauritius, Suriname, Timor-Leste, and Trinidad and Tobago—where CC issues were not substantively raised in Fund surveillance. In particular, in Trinidad and Tobago, there was almost no coverage of these issues in surveillance, notwithstanding many publicly known challenges, including a rise in sea levels, increased flooding, unpredictability of weather conditions, hillside erosion and the loss of coastal habitats. In Djibouti, the issue was raised in an IMF staff Working Paper (Kireyev, 2018) but not in the Article IV consultation staff report; and in the case of Mauritius, both the World Bank and the World Risk Reports have ranked the country among the top 20 countries with the highest disaster risk for several years.

55. Overall, Fund staff, supported by a steady flow of policy guidance, staff papers and additional surveillance tools, notably enhancements to the DSA framework, were able to build up a substantive contribution to surveillance and policy advice on managing the fiscal policy challenges brought about by ND&CC. Advice was tailored and progressively deepened in its sophistication over the decade. But there is still much to be done in persuading SDS to implement the fiscal and budgetary policy reforms that ongoing ND&CC developments will necessitate. Moreover, some gaps in coverage still persist for some countries where ND&CC risks seem germane. Finally, one senior staff member highlighted in an interview that World Bank participation in CCPAs was vital, given its strong technical expertise on ND&CC issues and its significant role in their preparation, but also noted the apparent limited incentive of the Bank to participate in CCPA missions. Since that conversation, the Bank decided to not participate in CCPA in the future, but to focus on its own new instrument, the Country Climate and Development Report.

F. SDS-Initiated Innovations to Build Fiscal Resiliency

56. SDS have innovated in their search for fiscal resiliency, notably through the development of CBI programs. In the final decades of the last century, Dominica and St. Kitts and Nevis introduced legislation that would provide citizenship for non-residents in exchange for investments in their economies (principally in the form of real estate). During 2010–2014, several other Caribbean economies—notably Antigua and Barbuda, Grenada and St. Lucia pursued similar initiatives and some other SDS subsequently followed, including the Union of the Comoros, Samoa, Vanuatu, and Montenegro (the latter most recently in 2019). [24] By the middle of the decade, Caribbean economies saw an upsurge in the uptake for these programs, which began to be elaborated in terms of the amounts of contributions required and the purposes funded by these contributions. The programs yielded substantial budget revenues, in a few cases exceeding 20 percent of GDP in a given year (for example, in Dominica in 2015/2016).

[24] Gold and Myrvoda (2017) reviewed experience with economic citizenship programs in the Caribbean along with their macroeconomic implications and a prudent management framework.

57. Fund surveillance covered the macroeconomic, fiscal and political economy issues raised by these programs in detail. Coverage was reflected in text boxes, annexes and SIP chapters in surveillance and Fund-supported program reports in Grenada (2014, 2015), St. Kitts and Nevis (2014, 2017), and Dominica (2017).[25] In their work, Fund staff, supported by Fund research (Srinivasan and others, 2017), identified several characteristics of the programs that raised challenges for the effective conduct of fiscal policy. Specifically, these included their unpredictable windfall nature,[26] their volatility over time, and the competition by countries for these income flows, thereby affecting their size, timing and ultimate reliability as revenue sources.

58. Staff have advised country authorities to address the risks associated with such programs at an early stage in their conceptualization and development. The risks identified included their potential for creating Dutch Disease problems, potential bubble effects on the real estate market with effects on the financial sector, and the difficulties posed for budgetary planning, given the uncertainty and magnitude of the funds involved. Staff also cautioned that the programs could divert administrative efforts away from grant-application efforts, dilute tax mobilization efforts, and bias the structure of government budgets if receipts were allocated to recurrent expenditure programs, off-budget institutions[27] or government employment that, once established, would be difficult to terminate. The latter, risks particularly prevalent in SDS with Fund-supported programs, was of particular concern, distorting benefits away from necessary public investment programs and conflicting with fiscal consolidation efforts to bring down excessive debt ratios. Staff also pointed to potential reputational risks in offering citizenship rights, including potential for gray listing and consequent problems in terms of a country's access to global financial systems and correspondent banking relationships.[28] Staff expressed concerns about the financial and legal risks entailed for these countries if not managed and vetted correctly. Later in the evaluation period, the staff advised that the accumulated savings from contributions should be allocated to ND funds that could be used for climate-resilient infrastructure or relief and reconstruction efforts.

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[25] SIP Chapter on Optimal Management of CBI Program Revenues in Dominica (2017), Annexes on Strengthening the Transparency and Governance of Grenada's CBI Program (2014, 2015); Box on Macroeconomic Linkages of the CBI Program in St. Kitts and Nevis (2014), Annex on the Optimal Management of CBI Inflows (St. Kitts and Nevis, 2014) and CBI Inflows and Financial Stability in St. Kitts and Nevis (2017); Annex on Economic Citizenship Programs in Vanuatu and around the World (2015); and Box on CBI Program in St. Lucia (2015).

[26] Were advanced countries to decide not to accept these passports in granting visas, the value of the CBI programs could swiftly diminish, with equally sharp effects on the windfall incomes from these programs. Also, given the competitive nature of these programs across the Caribbean, a race-to-the-bottom in terms of their quality could also diminish their perceived value as credible passports.

[27] For example, in Dominica, contributions to the off-budget Sugar Industry Diversification Foundation led to concerns on duplication with other government programs.

[28] On these issues, the countries appear to have moved swiftly, in concert with the IMF and the World Bank, to address these non-compliance concerns.

G. State-Owned Enterprises

59. Surveillance and program documents throughout the evaluation period drew attention to the challenges created by SOEs in achieving fiscal sustainability. Staff took extensive steps to clarify and highlight these challenges. During 2010–2014, 18 boxes or annexes in Article IV consultation staff reports focused on SOE issues (and one SIP chapter for Mauritius addressed the issue). In the second half of the decade, attention increased significantly, with 29 boxes and annexes featuring in staff reports. A review of these documents highlights 10 recurring themes in Fund policy advice (Table 3). Altogether, these issues are relevant in almost three-quarters (24) of SDS members.

Table 3. Common Policy Challenges of SOEs Identified in Article IV Consultation Staff Reports During 2010–2019

Requiring budget transfers	Antigua and Barbuda, Barbados, Cabo Verde, Union of the Comoros, Eswatini, Fiji, Grenada, Maldives, Marshall Islands, Mauritius, Palau, Samoa, Democratic Republic of São Tomé and Principe, St. Vincent and the Grenadines, Seychelles, Trinidad and Tobago, Tuvalu, Vanuatu
Involves cross-arrears	Antigua and Barbuda, Union of the Comoros, Grenada, Palau, Kiribati
Source of inefficiency in economy; impedes private sector involvement	Marshall Islands, Samoa, Democratic Republic of São Tomé and Principe
Source of contingent liabilities	Antigua and Barbuda, Cabo Verde, Eswatini, Grenada, Micronesia, Seychelles, St. Kitts and Nevis
Lack of financial control by the central government	The Bahamas, Barbados, Cabo Verde, Djibouti, Eswatini, Marshall Islands, St. Kitts and Nevis, Trinidad and Tobago, Tuvalu, Vanuatu
Significant share in GDP	Cabo Verde, Maldives, Mauritius, Micronesia, Nauru, Seychelles
Significant external debt	Cabo Verde, Djibouti, Eswatini, Maldives, Mauritius, Samoa, Seychelles, Vanuatu
Failure to comply with financial reporting requirements to government	Antigua and Barbuda, Barbados, Cabo Verde, Dominica, Grenada, Kiribati, Maldives, Trinidad and Tobago, Vanuatu
Not charging full cost recovery prices	The Bahamas, Barbados, Fiji, Grenada, Kiribati, Marshall Islands, Mauritius, Democratic Republic of São Tomé and Principe, Seychelles, Trinidad and Tobago,
Involved in the delivery of essential services	Antigua & Barbuda, Djibouti, Eswatini, Marshall Islands

Source: IMF program documentation for SDS (2010–2019).

60. Fund surveillance paid attention to SOE concerns in both program and non-program contexts. Among six SDS with Fund-supported programs, three surveillance discussions focusing on SOE challenges took place during the period of their arrangements, with staff reports evidencing considerable strategic and financial support provided by Caribbean Technical Assistance Center (CARTAC) and the World Bank. There was also considerable focus in surveillance in four non-program members in the Pacific Islands (the Marshall Islands, Samoa,

Tuvalu, and Vanuatu) in addition to work in Eswatini. Fund engagement in the Pacific was strongly supported by the IMF Pacific Financial Technical Assistance Center (PFTAC) and the Asian Development Bank (ADB), with staff reports providing a substantial discussion of the policy requirements for addressing sectoral challenges. Staff's policy focus responded to problems highlighted in Article IV consultation staff reports, with specific approaches suggested for improving governance of the SOE sector, tariff reforms, the need to rationalize the sector through privatization or restructuring, cutbacks in government financial support for SOEs, and strengthening the competitive framework with the private sector.

61. There is considerable evidence of traction in Fund engagement on SOE issues. Progress, albeit slow, occurred in several areas. Much of the progress involved the establishment of a SOE policy and regulatory framework, for example in Grenada and St. Kitts and Nevis) and a financial reporting process. Some arrears reduction occurred (in Grenada) but far less in the case of the Union of the Comoros during 2010–2013. Some reduction in budgetary transfers has been achieved, albeit fitfully, for example in Barbados; and tariff adjustments have occurred for several SOEs, albeit slowly, including in the Seychelles. Some privatizations have also been accomplished (Cabo Verde), while restructuring or privatization of others has proven difficult, due to the complexity of the operational issues involved (São Tomé and Principe, Grenada, St. Kitts and Nevis and Seychelles)[29] and the challenges faced in SDS in securing private involvement in areas dominated by public enterprises.

H. Assessment

62. Surveillance on fiscal issues for SDS underwent a sea change during the decade. In part, the legacy of the global financial crisis on debt levels forced a discussion of what policy measures and approaches to fiscal policy management would be needed to restore fiscal and debt sustainability, with this work reinforced by new IMF research findings distinguishing the very particular challenges faced by the economies of SDS. Adding growing evidence on CC and, in particular, its implication for the frequency and severity of NDs, the 2014 SGN pushed Fund to begin to deepen the focus of Article IV consultation discussions with SDS officials on the key policy issues and reforms necessary to achieve greater fiscal resiliency. The 2014 and 2017 SGNs led to an intensified focus on rethinking how to mobilize additional fiscal revenue; how to staunch fiscal bleeding from wasteful SOEs, untargeted subsidies, and excessive civil service wage outlays; how to create a more disciplined framework for fiscal and budgetary policy management; and finally, how to grapple with the fiscal shocks and setbacks caused by a changing weather environment (though not with any expectation of a further shock from a global pandemic). Article IV consultation staff reports also differentiated the particular (and often difficult) challenges faced by SDS blessed with the reality of the potential of significant natural resources or financial legacies. Finally, the CCPAs conducted for a number of SDS provided more

[29] To illustrate the difficulties, in São Tomé and Principe, the total gross value of domestic arrears of SOEs reached 60 percent of GDP in 2017 (in unconsolidated terms) of which 14 percent of GDP was owed by the government and 3 percent of GDP owed to the government.

in-depth analysis of the fiscal consequences and hiring needs of adapting to CC. The challenge that global CC mitigation might create "stranded assets" from these resources was not yet on the Fund's policy radar during the evaluation period.

63. Notwithstanding this considerable attention and the use of more sophisticated analytical tools, the traction of Fund advice has been uneven. There were certainly some important successes, reflecting the combined involvement of the Fund's surveillance and CD work (and in some cases other bilateral and multilateral actions). Most of these successes related to specific policy efforts. As noted earlier, in the tax policy sphere, the introduction of a VAT or reforms to an existing VAT occurred in eight SDS; overall revenue performance improved for two-thirds of SDS. Efforts to reduce wasteful and unproductive expenditure proved more difficult, though reductions in the public sector's wage share in GDP occurred in eight SDS. The dialogue on the macro fiscal framework in SDS was undoubtedly enhanced by surveillance, though the immediate fruits of this effort remained fairly limited (as indicated in Table 2). Progress was also achieved in rationalizing the state enterprise sector. Particularly important, both the increasingly evident threat from nature and the efforts of the IMF have catalyzed a much greater focus on the fiscal challenges posed by ND&CC risks.

64. Nevertheless, this mixed experience underlines the political economy challenges involved in achieving both a rethinking of policy by SDS policymakers and implementing specific policy reforms. Whether in the revenue, expenditure, SOE or fiscal management spheres, achieving real institutional change proved difficult, particularly with the limitations posed by an SDS environment. The possibility of achieving quick policy wins, e.g., from CBI initiatives, often confronted both unanticipated obstacles and intensified competition from other SDS.

65. Progress in achieving policy traction was often set back by the impact of NDs, not to mention the ups and downs of political change or the legacy of the economic and institutional environment in specific SDS. Given the limits on the Fund's surveillance resources, the staff's follow-through with the SGN's impetus was itself uneven. Experience suggests the need for greater attention to providing more concrete, specific advice and to more sustained follow-up with authorities. Moreover, the identification of ND&CC as a key fiscal issue was only the beginning in terms of the conceptual efforts required to grapple with the range of fiscal policy changes that SDS would need to confront as our understanding of the changing global climate environment matures.

V. PROGRAMS AND EMERGENCY LENDING

66. SDS made recourse to Fund-supported programs on a number of occasions during the evaluation period, in most cases to support efforts to address unsustainable debt burdens. They also used emergency financing to help cope with the heavy economic costs from physical NDs and most recently the COVID-19 pandemic. A number of tourism-based SDS emerged with high levels of public debt from the global financial crisis (Yartey, 2012; and IMF, 2013c), and some ultimately sought IMF-supported programs to frame their efforts in negotiating debt

restructuring operations to restore sustainable fiscal and debt positions, including Antigua and Barbuda's debt restructuring in the context of its 2010–2013 SBA; Grenada's 2013–2015 debt restructuring effort in the context of its 2014–2017 Extended Credit Facility program; St. Kitts and Nevis' 2012 restructuring during its 2011–2014 Stand-By Arrangement (SBA) and Post-Program Monitoring in 2015; Barbados' major 2018 debt restructuring, which occurred after years of fiscal instability and in the context of home-grown policy reforms (supported by an Extended Fund Facility (EFF) arrangement in 2018–2020); and Seychelles' debt restructuring in the context of successive EFF arrangements during 2010–2017.[30, 31] Only Cabo Verde's access to a Policy Support Instrument in 2010–2011 was unrelated to debt restructuring.

67. Most of these programs ultimately saw debt ratios significantly reduced to levels closer to their original debt targets, partly through fiscal consolidation, and through debt restructuring under the auspices of the Paris Club or through direct negotiation with private creditors.[32] In all cases, it was recognized that reaching debt targets would require that "fiscal policy discipline holds" after the completion of the program.[33] With IMF technical support, Grenada and Barbados sought to reduce exposure to ND risks through inclusion of contingency clauses providing additional debt relief in the event of an ND in their debt restructuring agreements. However, debt operations still left some countries with a high level of public gross financing requirements, particularly where much of the debt was domestic debt held by local investors and financial intermediaries, which limited the scope for deep restructuring. For Seychelles, the IMF's Executive Board emphasized that despite the debt restructuring, Seychelles still had not achieved its medium-term debt target (of 50 percent) and that additional fiscal space would be needed over the medium term to finance climate-resilient investments and to deal with its vulnerability to both external shocks and, over the longer term, to CC.

68. Beyond debt restructuring, Fund-supported programs also emphasized the role of debt anchors in support of fiscal consolidation (in the cases of Grenada, St. Kitts and Nevis and Barbados) and the role that could be played by enhanced fiscal responsibility legislation. Grenada and Barbados ultimately sought the creation of fiscal space through ND-related debt reduction clauses in the context of their debt restructuring. The Fund-supported programs also promoted efforts to foster fiscal resiliency, particularly in the context of their exposure to NDs (initiatives which were encouraged in the 2017 SGN). The three-year SBA for Grenada approved in 2014 recognized NDs as a main risk to the macroeconomic outlook; with IMF CD support, it contributed to the 2015 passage of fiscal responsibility legislation that was intended to lead to a transition to a rule-based fiscal framework. It was the first of the Eastern Caribbean Currency

[30] Some of the program involvement preceded the evaluation period, notably Grenada (PRGF during 2008–2010) and Seychelles (SBA 2009–2010).

[31] Some of this experience is discussed in Okwuokei and van Selm (2017), and Anthony and others (2020).

[32] Grenada's overall debt-to-GDP ratio fell from 108 percent in 2013 to 83 percent in 2016. Following support by external creditors and a Paris Club debt restructuring, Seychelles' debt-to-GDP ratio fell by two-thirds by 2015.

[33] IMF (2015b).

Union countries to put in place such legislation. While the legislation focused on the promotion of debt sustainability, an escape clause gave the government the flexibility to address NDs or public health emergencies.

69. However, despite the attention in the Fund-supported program context, progress in the creation of ND resiliency funds or fiscal buffers, took place slowly. While authorities were often supportive of the Fund's policy ideas, actual implementation was slow to materialize. There are a few cases of emergency funds having been announced. In 2015, Grenada established a CBI-financed National Transformation Fund (NTF) which potentially could be used to finance post-disaster reconstruction relief. It supplemented the very limited contingency funds mandated through budget contributions (though the NTF could be used for other purposes). If adequately funded in coming years, this will offer greater financial resilience in the face of its vulnerability to NDs. Dominica in 2016 (in connection with an IMF-supported program and TA) passed legislation to create a Vulnerability Risk and Resilience Fund to be financed in part by CBI program resources and managed by the Eastern Caribbean Central Bank. Similarly, in the context of its Fund-supported program, St. Kitts and Nevis indicated in 2017 that it was creating a Growth and Resilience Fund. However, there is little evidence that the funds in Dominica and St. Kitts and Nevis were actually established or functioning or linked to fiscal responsibility legislation (as in the case of Grenada).

70. In varying degrees, Fund-supported programs saw the introduction of other critical fiscal reforms, including in tax policy supported by Fund CD (some relating to a VAT, others in reducing questionable tax incentives), tax and customs administration, public financial management and improved oversight and reduced transfers to SOEs. Grenada introduced reforms in public debt management and PFM.

71. During the period, several Fund-supported programs focused significant efforts on reform of the SOE sector. These included Grenada during 2014–2017, Seychelles (2010–2019), Cabo Verde (2019), St. Kitts and Nevis (2011–2015), Union of the Comoros (2010–2013), and the Democratic Republic of São Tomé and Principe (2010–2018). The staff's approach, usually with World Bank or RCDC support, involved several key dimensions: (i) strengthening the regulatory environment, typically by the Finance Ministry, leading to enhanced financial reporting, development of a performance monitoring framework, limits on short-term debt financing to prevent contingent liabilities, review of pricing policies, restrictions on non-personnel expenditures, resolution of arrears, efforts to harmonize employment policies; and addressing weaknesses in pension plans; (ii) formulation of an overall strategy to address the difficulties and financial position of the different SOE's principal challenges; and (iii) institution-specific privatization or restructuring efforts, particularly for the key loss-making enterprises.

72. Experience with programs during the evaluation period offered useful practical lessons on the kind of challenges that could arise in designing a Fund program in support of enhanced fiscal resiliency to NDs. As an example, the Fund-supported program for St. Kitts and Nevis focused on building up a savings fund through the resources derived from their CBI initiative.

The potential for such a savings fund proved greater than expected, with a substantial inflow of CBI revenues. But because such resources emerged only late in the program period, the fiscal balance "adjustors" specified in the Fund-supported program did not end up capturing most of these resources in the savings fund. Most of the resources ended up financing higher-than-anticipated current expenditure rather than leading to higher savings, a repayment of debt, or the completion of important infrastructural investments. As a result, the post-program DSA suggested that St. Kitts and Nevis was still in a highly vulnerable debt position, with a high level of public gross financing requirements. Indeed, one of the lessons drawn in the ex post review of its program was that "pursuing a sovereign wealth fund linked to a fiscal rule based on a non-CBI primary balance[34] as well as the unification of fiscal activity…would be important" in "building greater resilience."

73. Similarly, experience during the evaluation period underlines that political will was ultimately a critical factor in determining whether a Fund-supported adjustment program was effective. For example, Grenada's initial Poverty Reduction and Growth Facility (PRGF) program in 2008–2010 and even its later 2014 Extended Credit Facility arrangement had only limited effectiveness, with much greater progress only realized in 2015–2016. It took political change to open the window for Barbados to seek Fund support for its major restructuring of its heavy debt load in 2018. Being of only 15 months duration and subject to severe external pressures, Cabo Verde's policy coordination instrument-supported program was only modestly successful in its structural reforms.[35]

74. A fortiori, for the four SDS that have been categorized as "adjustment challenged" (Antigua and Barbuda, the Union of the Comoros, Eswatini, and the Democratic Republic of São Tomé and Principe), political economy issues—notably instability in political leadership, corruption, weak fiscal institutions, and inefficient but dominant SOEs—appear to explain the "teflon" quality in their lack of traction in policy reform efforts to achieve fiscal resiliency. The fragility of the political economy environment was combined with their exposure to a highly volatile revenue environment and ND shocks. It was not for an absence of Fund-supported programs. Excepting Eswatini (which peripatetically engaged in Staff Monitored Programs), São Tomé and Principe engaged with Fund-program support for much of the decade (through 2017), and the other two engaged in Fund-supported programs in the first few years after 2010. But these countries also benefited from opportunistic sources of funding that did not entail conditionality for their support. Fund staff consistently advocated approaches to deal with the sources of economic volatility, not only in program support but in surveillance and with capacity building and TA support. But ultimately, as suggested in an ex-post peer review assessment in 2019 of the experience with the Democratic Republic of São Tomé and Principe, the

[34] Or, more broadly, non-renewable resource revenues.

[35] Cabo Verde subsequently sought Fund guidance (as opposed to financial support) in the context of a Policy Coordination Instrument during 2019.

preconditions for success may have required a very different kind of policy engagement than was possible from the IMF.

75. The Fund's facilities to provide emergency support in response to ND and health-related shocks—the Rapid Credit Facility (RCF) and the Rapid Financing Instrument (RFI)—provided quick financial support to SDS without ex post conditionality. Seven SDS availed themselves of these facilities during 2010–2019 mainly in response to severe tropical storms or hurricanes. It should be recognized that use of emergency financing is by its nature a rapid response without ex post conditionality, although to qualify for such financing a country needs to show the general policies it plans to pursue to address its balance of payment (BOP) difficulties and be judged as having sustainable debt. Twelve SDS used these facilities during the COVID-19 pandemic in 2020. One factor constraining interest in use of IMF emergency financing has been low access related to the scale of the problem. Recognition of this concern has led to increases in access to such facilities, first in 2019 and then in 2020 (on a temporary basis to handle the pandemic).

Assessment

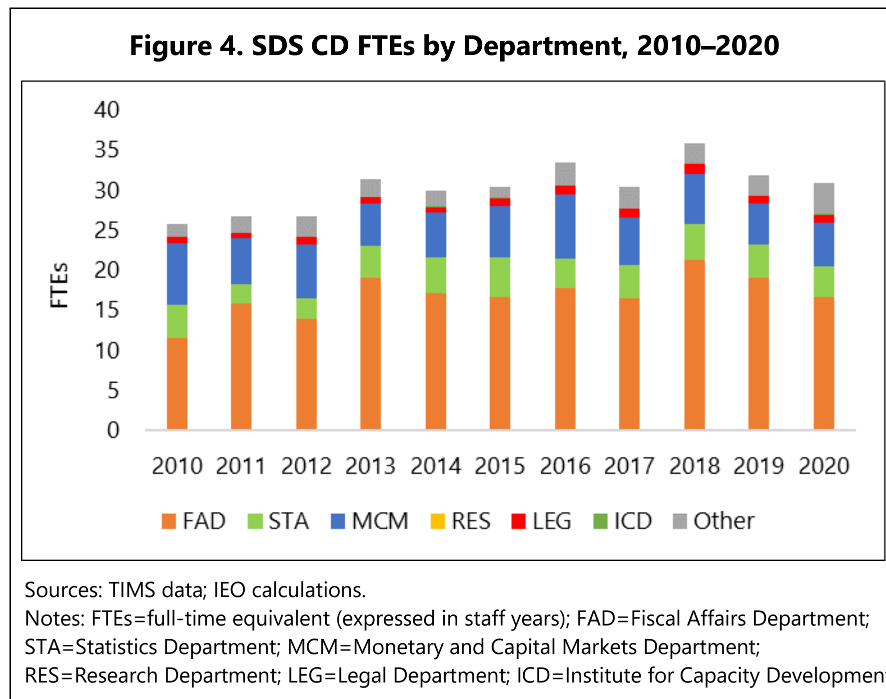
76. Fund-supported programs with conditionality played an important supporting role in restoring fiscal resiliency to a number of SDS, particularly for those SDS that entered the decade with unsustainable debt ratios. This was particularly the case for tourism-based economies, both in the Caribbean and among some of the island SDS of Africa. In most cases, this occurred through their pairing with debt restructuring operations with other lenders. In some countries, the programs ultimately catalysed important policy reforms—in tax policy measures, in the adoption of formal fiscal policy frameworks and fiscal rules, and in the formation of savings or resiliency funds. The emergency lending facilities of the Fund also served as an important source of quick funding for SDS grappling with the impact of unanticipated NDs and with the pandemic, although such financing does not involve ex post conditionality.

77. But the limitations of Fund-supported programs were also illustrated. Even among the more successful recipients of Fund financial support, progress proved uneven, with the time required to implement reforms much longer than originally envisaged. The sustainability and management of these reforms will also prove a continuing issue for Fund surveillance looking forward. Political will ultimately proved to be the decisive factor in explaining the success (e.g., in Grenada and Barbados) or failure of Fund-supported programs (in four other SDS). In the latter SDS, Fund-supported programs failed to achieve significant traction in policy reforms or in terms of restored fiscal resiliency. Yet it is difficult to find fault with the efforts of Fund staff in seeking to work with these countries to achieve policy reform, despite the unsupportive and challenging policy environment.

VI. CAPACITY DEVELOPMENT

78. IMF CD played an important and often integral role in supporting surveillance and program work on fiscal policy issues in SDS.[36] Over the evaluation period, four Departments (Fiscal Affairs Department (FAD), Statistics Department (STA), Monetary and Capital Markets Department (MCM) and Legal Department (LEG)) provided the vast majority of CD to SDS (Figure 4). In each year during the evaluation period, the largest share of Fund CD to SDS was provided by FAD; the department provided an average of 17 full-time equivalent (FTE) years of staff resources to SDS (185 FTEs over the entire evaluation period).

Figure 4. SDS CD FTEs by Department, 2010–2020



Sources: TIMS data; IEO calculations.
Notes: FTEs=full-time equivalent (expressed in staff years); FAD=Fiscal Affairs Department; STA=Statistics Department; MCM=Monetary and Capital Markets Department; RES=Research Department; LEG=Legal Department; ICD=Institute for Capacity Development.

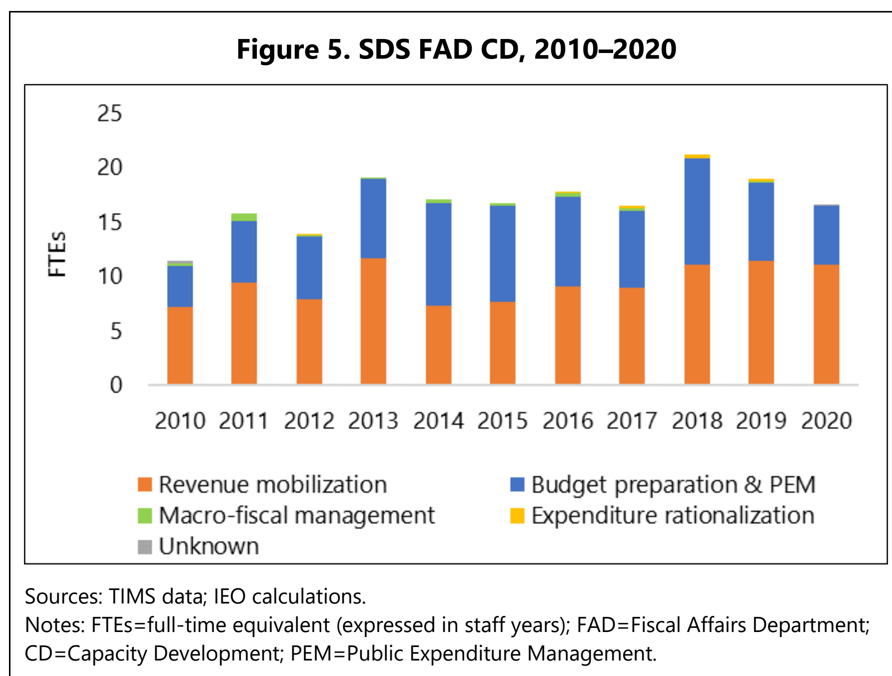
79. Consistent with policy guidance in both SGNs, FAD's CD support to SDS focused on revenue mobilization, budget preparation and public expenditure management (Figure 5). Statistics, derived from aggregate data on CD staff deployment, are in line with the reports provided in the standard Article IV consultation staff report Information Annex which in some

[36] As noted earlier, IMF provision of CD to SDS is covered extensively in de Las Casas and Balasubramanian (2022). Also see IMF (2019b). The current paper briefly highlights specific aspects of Fund CD related to fiscal policy.

cases includes details on the focus of mission and deployment of short or long-term experts to a country by CD departments.[37]

80. CD on public financial management focused specifically on issues related to the budget process, treasury systems, and more recently on the management and evaluation of public investments (see IMF, 2018c; and Mitchell and others, 2020). In at least 15 of the SDS, public expenditure and financial accountability assessments were carried out on a self-assessment basis with Fund support, leading then to the formulation of a road map for action to strengthen PFM processes. Since 2016, five Public Investment Management Assessments have been carried out in SDS, reflecting staff's awareness of the distinct and difficult challenges posed in the management of the capital expenditure sphere of the budget.

Figure 5. SDS FAD CD, 2010–2020



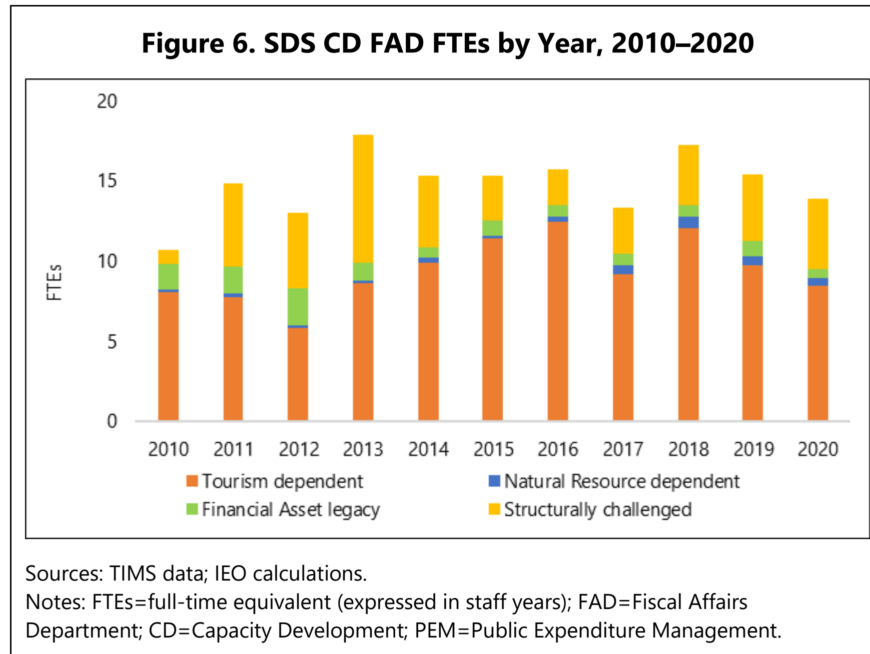
Sources: TIMS data; IEO calculations.
Notes: FTEs=full-time equivalent (expressed in staff years); FAD=Fiscal Affairs Department; CD=Capacity Development; PEM=Public Expenditure Management.

81. In the revenue area, there has been frequent and steady provision of TA for the purposes of revenue and customs administration reform as well tax policy guidance for SDS (outside of the surveillance channel for policy guidance). Introduction of more computerized systems of modern revenue collection and public financial management were recognized as essential in enabling SDS to implement effective policies in response to the human resource challenges faced by SDS.

[37] Usually, an AIV staff report's Information Annex provides a listing of the specific CD mission assistance provided by Fund departments during some period preceding the AIV. There is not a standard format for how this data is provided. The Information Annex may also provide limited information on relations with the RCDC relevant to a country. For the most part, more detail on the CD provided by an RCDC can only be obtained from the reports of the RCDC.

82. Figure 6 below shows that the distribution of CD provided by FAD across the four SDS groups evolved over the evaluation period. The tourism dependent economies received about half of CD in SDS. Staff also devoted a substantial share of FAD CD resources to the four most structurally challenged SDS, signalling focused attention to the fiscal policy problems facing these countries. From 2017, attention to fiscal policy constraints of natural resource-based countries increased significantly, more than trebling since the beginning of the evaluation period.[38]

Figure 6. SDS CD FAD FTEs by Year, 2010–2020



Sources: TIMS data; IEO calculations.
Notes: FTEs=full-time equivalent (expressed in staff years); FAD=Fiscal Affairs Department; CD=Capacity Development; PEM=Public Expenditure Management.

83. Evidence over the evaluation period shows policy advice in the program context was the focus of significant and frequent CD to facilitate policy implementation. This was the case regarding tax policy reform (viz., in St. Vincent and the Grenadines and St. Lucia), limiting tax exemptions and incentives (Cabo Verde, Dominica, and Grenada), and revenue and customs administration reform (e.g., in Cabo Verde, Djibouti, Dominica, Eswatini, Grenada, Democratic Republic of São Tomé and Principe, Solomon Islands, and St. Lucia). The connection is also visible on issues of fiscal resilience and on the roles of an MTFF, fiscal responsibility legislation, and fiscal rules in support of achieving fiscal consolidation. Thus, Fund TA was provided to Dominica to explore the creation of a National Reserve Fund using Economic Citizenship Program contributions, Grenada in relation to the formation of its NTF, and St. Vincent and the Grenadines in the preparation of an MTFF.

[38] These results need to be qualified by recognition that SDS benefited from their close interaction with the respective RCDC as well as the involvement of other regional CD providers (Asian Development Bank, Inter-American Development Bank, African Development Bank).

84. How effective has fiscal CD to SDS been? The assessments evaluating the effectiveness of capacity building efforts are provided most thoroughly in dedicated studies by CD-providing departments and by external evaluations of RCDCs. Two studies focusing on PFM CD provided by CARTAC (Watson and others, 2015) and PFTAC (Allen and others, 2020), respectively, highlighted the challenges in providing CD in countries with small populations. While both studies were complimentary about the value of the CD efforts, Watson and others (2015) noted the "inability to develop self-sustaining capacity and in-depth specializations within an agency" that must be recognized in any reform effort and highlights the fragmentation of donor support which is "particularly acute in PFM." Allen and others (2020) noted the variable performance outcomes, noting that PFM reforms suffered from the small size and low capacity of many Pacific Island countries, "poorly designed PFM roadmaps, variable political support and vulnerability to natural disasters" and the need for perseverance by countries in implementing reforms and leadership by finance ministries [as] critical."

85. Staff interviews support these assessments. One RCDC staff member underscored the impact of the limited number of fiscal officials in SDS. For example, RCDC CD engagement was hobbled by the disruption from the absences due to workshops held by development partners in the region. RCDCs also provide CD to non-Fund members who contribute to RCDC financing, further limiting CD resources available to SDS. RCDC officials also noted that their CD work, both in the Pacific and Caribbean, was enhanced by their interaction with other regional CD providers. RCDCs have a beneficial impact on surveillance and program efforts, reflecting that their good relationships with authorities and civil society sometimes played a critical role in ensuring continuity in knowledge, given the frequent change in Article IV consultation mission leadership to SDS. They also fostered continuity in policy advice in between two-year Article IV consultation mission visits and during the recent COVID pandemic. Their role was said to be particularly valuable in the Pacific region, where officials have had a more limited past exposure to macro policy issues (compared to Caribbean SDS). RCDC staff also noted that in the Caribbean and Pacific, the Fund's macro surveillance benefited from the work of a macro programming adviser, backstopped by the relevant area department.

Assessment

86. In sum, the importance of the Fund's CD effort on fiscal issues reflects the burden faced by SDS fiscal administrations from their small size and their lack of a substantial body of skilled manpower, as well as the high turnover due to frequent departures of officials to other jobs. Overall, CD-supported fiscal priorities were well identified in surveillance and program work, although progress on traction was mixed, in part to institutional obstacles inherent in the SDS context. The use of RCDCs as CD providers was particularly important as it facilitated more frequent hands-on provision of CD and a sharing of regional good practices than could have been readily provided from Fund headquarters, while allowing the Fund to coordinate this CD with the detailed policy priorities emerging in the context of surveillance and Fund-supported programs. Such CD should be seen as part and parcel of the larger knowledge transmission from

the IMF reflected in the substantive policy advice provided in Article IV consultation staff report annexes, boxes and SIP chapters discussed earlier. The recent 2020 decision to augment RCDC manpower in the sphere of debt management in the Caribbean and Pacific regions to help address concerns on debt vulnerability, highlights that RCDCs may need to play a broadened role beyond traditional fiscal operational TA support. More in-depth assessments of fiscal risk exposure on ND&CC may be needed for the most exposed SDS.

VII. Debt Sustainability and Fiscal Policy

A. Evolution of Debt Sustainability Assessments

87. As noted earlier, DSAs have been an integral part of the IMF's toolkit for almost all surveillance and program-related discussions of fiscal resilience in SDS. Because they are PRGT-eligible, two-thirds of SDS are subject to the LIC DSA framework carried out jointly by the IMF and the World Bank, while the remainder are subject to the DSA for market access countries (MAC DSA).[39] Two-thirds of the latter group receive the more detailed analysis for high-scrutiny market-access countries.[40] Both these frameworks at the Fund have evolved considerably over the evaluation period based on in-depth reviews of the experience with the methodologies. This section reviews how the DSA framework's evolution during the evaluation period impacted the quality of the Fund's assessment of SDS fiscal and debt sustainability risks.

88. Given the substantial evolution in the Fund's DSA toolkit, the following brief assessment focuses on the most recent SDS DSAs prepared during the period January 2019–end-June 2020. It considers how effectively the implications of DSA results were embedded in the Fund's fiscal policy advice.

89. Most Caribbean and African SDS began the decade with weak debt-carrying capacity. In many Caribbean SDS, debt ratios increased further during the decade, in part because of NDs. A few, including Barbados, Belize, Grenada and St. Kitts and Nevis, engaged in debt restructuring operations during the decade. Some low-income Pacific SDS also had weak debt carrying capacity during the period, despite having a significant endowment of financial assets in a number of cases. Other SDS began the decade with significant natural resource endowments, which for some, provided a significant asset offset to their debts.

90. For most of the evaluation period, for emerging market SDS with high debt ratios and access to capital markets (Table 4), intensified risk-focused DSAs for MACs were based on the review of the framework for fiscal policy and DSA (IMF, 2011) and 2013 Staff Guidance Note

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[39] DSAs using the LIC-DSF template are required for all PRGT-eligible countries that also have access to IDA resources and all countries that are eligible for IDA grants.

[40] High-scrutiny MACs are countries with debt-to-GDP ratios exceeding 50 percent or debt financing exceeding 10 percent of GDP. Among IMF SDS members, these include Antigua and Barbuda, Barbados, Belize, St. Lucia, Mauritius, Seychelles, Montenegro, Suriname, Nauru, and, in the latter part of the evaluation period, Eswatini.

(IMF, 2013d).[41] Further reforms in the DSA methodology were approved in 2021 based on a recent staff paper (IMF, 2021). The MAC DSF will be renamed as the "Sovereign Risk and Debt Sustainability Framework," with its output referred to as a "Sovereign Risk and Debt Sustainability Analysis" (IMF, 2021). These changes specifically addressed some fiscal risks pertinent for SDS (including NDs and long-run impacts related to CC, SOE risks, commodity price shocks, contingent liabilities, and quasi-fiscal activities related to public banks).

Table 4. SDS Debt Sustainability Assessment

Sustainable	Low Risk	Moderate Risk	High Risk	Unsustainable	In Debt Distress
Mauritius,* Montenegro,* Nauru,* Palau,* Barbados,* Seychelles*	**DR Timor-Leste**	The Bahamas,* **Bhutan, Comoros,** *Fiji*,* **Guyana, Solomon Islands, Vanuatu**	**Djibouti,** *Dominica, Cabo Verde,* **Kiribati, Maldives, Marshall Islands, Micronesia,** *St. Vincent and Grenadines,* **Samoa, Tonga, Tuvalu**	Antigua and Barbuda*	*Grenada,* **DR São Tomé and Principe**
	Belize*: vulnerable subject to risks. St. Kitts*: Vulnerable to a range of risks. *St. Lucia*:* Debt vulnerabilities are elevated. Trinidad and Tobago*: Vulnerable to risks. Suriname*: Vulnerable to risks and various shocks. Eswatini*: Vulnerable to various risks.				

Source: SDS DSAs completed in 2017–2020.
Notes: In bold: PRGT-eligible (i.e., concessional resources); in italics: Blend (PRGT and non-concessional resources); and otherwise: non-concessional.
Asterisk: MAC DSA.

91. For SDS members subject to the LIC-DSA, several important modifications enhanced the complexity, significance and relevance of the DSA analytical framework. In part, these changes built on a staff paper on small state resilience to ND&CC (IMF, 2016) which underscored the frequency and impact of ND shocks and their impact on the fiscal policy framework. In late 2017, the Board approved important reforms to the LIC-DSA framework (IMF, 2017c) which were subsequently reflected in a 2018 Guidance Note (IMF, 2018a). The most important modification was to better capture the risks and likely effects that could arise were a substantial ND to occur in the five years following an assessment and potentially within the following two decades. These changes were elaborated in a June 2019 staff paper (IMF, 2019a).

92. The 2018 revisions aimed at a more effective exploration of the quantitative ramifications of the different risks to which they could be exposed, including risks originating in central, state and local governments, public off-budget entities and SOEs. The revisions enabled staff to

[41] This called for intensified risk analysis assessing the realism of the baseline scenario, vulnerability of the debt profile, sensitivity to macro-fiscal risks and contingent liabilities, with risk reporting using heat maps.

consider the possibility of a government having to "bail out" such potential obligations as an arbitrary "contingent liability that could occur during the projection period." "Tailored shocks" could thus highlight the potential importance of such risks and how they could affect the debt ratio looking forward. These revisions thus mirrored DSA tools already in place for under the MAC DSA. Such approaches to address SOE-related risks have been applied in DSAs for Fiji, the Union of the Comoros, Mauritius, Micronesia, Palau, Solomon Islands, and Trinidad and Tobago.

93. The 2018 revisions also enabled incorporation into the standard framework of a ND shock that mirrored past historical experience. This included the effect of such shocks on the fiscal position in the years following the event, as well as on GDP and exports (specifically, assumed to occur in the second-year post DSA in the forecast). The new methodology allowed this type of shock to be further tailored, if necessary, to reflect the specific exposure of a particular country, given data on the past occurrence of such events. These changes have been applied for many Caribbean and Pacific Island SDS which are subject to the LIC-DSA, including Comoros, Grenada, Kiribati, Maldives, Marshall Islands, Samoa, São Tomé and Principe, Solomon Islands, St. Vincent and the Grenadines, Tonga, Tuvalu, and Vanuatu.[42]

94. The new LIC- and MAC DSA approaches also provided the opportunity to carefully tailor staff analysis to the specific country context and challenges faced by each SDS. In some cases, staff accepted the "proffered assumptions" on what would be the impact of a shock,[43] whereas in other cases, staff assumed a larger shock or a more frequent one in situations where this was a significant probability. In the case of Solomon Islands, staff assumed the standard shock plus a tailored shock, on the basis of external sources of information on such shocks (e.g., EM-DAT). In Palau (MAC DSA), the ND shock is merged with a shock to tourism through a growth shock. In a few other cases, staff not only incorporated a standard shock or a tailored shock (e.g., Kiribati), but also incorporated into their baseline fiscal policy scenario an assumed annual budgetary allocation that would reflect what additional financing would be required to build up a contingency fund to cover reconstruction and relief expenses in the event of a ND. In effect, for these cases (notably, Grenada, Dominica, St. Vincent and the Grenadines, Kiribati,[44] Maldives, Marshall Islands, Samoa, Solomon Islands), the DSA would be budgeting a part of the fiscal burden of their exposure to CC. One senior staff member emphasized that DSAs that embodied

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[42] Perhaps the most dramatic example is for Tuvalu, where the DSA assumed a catastrophic cyclone (like Cyclone Pam) in 2028, with damage of up to 30 percent of GDP, and with a widened fiscal deficit of 10 percent of GDP initially, compared to 6 percent in the baseline, with higher deficits in the two succeeding years, partly financed by a drawdown from the Tuvalu Trust Fund (see AIV Tuvalu 2018).

[43] As proposed in the 2018 Guidance Note.

[44] "Climate-change-related maintenance and contingency expenditures are assumed to be less than 1 percent of GDP in 2019 and gradually reach 6 percent of GDP in 2028 and remain at that level thereafter." "The World Bank estimates that the additional cost of coastal protection and infrastructure adaptation due to rainfall and temperature increases for Kiribati could amount to 12 percent of GDP annually by 2040. The DSA assumes that half of the costs will be borne by the budget while the rest is financed by development partners" (in AIV Kiribati, 2018).

CC and ND scenarios illustrate their impact on debt and fiscal dynamics and the role that resource mobilization could play.

95. The 2016 staff paper on ND&CC (IMF, 2016), observed that there were several countries where NDs had not occurred with sufficient frequency to prescribe the automatic use of the "standard" ND shock assumption. Consequently, staff applied widely differing, country-specific approaches to assessing debt sustainability in SDS. For example, in The Bahamas, in 2019, the staff constructed their own alternative scenario reflecting the country's experience with recent hurricanes); and in 2020, staff incorporated the real time impact of the COVID-19 pandemic and the effects of the recent hurricane Dorian. In Barbados, staff chose not to include a ND scenario in the DSA based on the historical low frequency of NDs for Barbados. In contrast, for Belize, St. Kitts and Nevis, and St. Lucia, staff chose to incorporate the standard ND shock into their most recent DSA.

B. Assessment and Key Findings on the Fund's DSA Analyses

96. A review of SDS DSAs over the period 2010–mid-2020 illustrates that these were generally competently and carefully carried out for the surveillance and program discussions that took place during the decade, highlighting whether a country's debt sustainability was in question. In recent DSAs, coverage of debt vulnerabilities and their impacts on fiscal policy has been extensive. Most DSAs since 2018, including those prepared prior to the COVID-19 pandemic, highlighted how many SDS have been subject to significant vulnerabilities in their debt position (Table 4).

97. Based on the DSAs through 2020, SDS assessed to be at high risk, having unsustainable debt levels, or in debt distress included virtually all of the Caribbean SDS and several African and Pacific SDS. Most DSAs emphasized the need for significant fiscal adjustment to restore debt sustainability, with specific detail on how fiscal consolidation should take place reflected in a country-specific analysis of the fiscal sector (in Fund surveillance and where applicable, in program documents). Typical components of Fund advice, inter alia included reframing the primary expenditure rule to create space for resilient investment, prioritizing efficient spending, maximizing the revenue potential of planned reforms, and developing new revenue sources. An emphasis on the role of fiscal responsibility legislation and fiscal rules in solidifying adherence to a fiscal path and advice on building up buffers was included in most DSAs, including for example those for Grenada and St. Lucia. In a few cases, DSAs underscored that fiscal adjustment alone would not be sufficient to bring the debt ratio to a sustainable level, and that some form of debt restructuring, or relief would be required as an additional initiative. These assessments reflected the more country-specific detailed analysis of the fiscal sector.

98. Reforms to the DSA methodology over the evaluation period helped improve the quality of assessments of risks to fiscal policy brought about by debt accumulation. Progressive improvements in the DSA methodology introduced more sophisticated ways to gauge the realism of debt projections for policies and the economic environment. Staff has compared

authorities' baseline scenarios, with both countries' past records and with alternative policy scenarios proposed by staff. Changes to the methodology also enabled projections to be stress-tested for the impact of potential unexpected shocks relevant to SDS, including NDs, SOE defaults and the unexpected emergence of contingent liabilities. It has also enabled a gauging of how much such shocks would throw baseline scenarios off-track. The further changes recently agreed for MACs further expand on these approaches. They include assessment of long-term risks (at least 10 years); allow for triggered stress-tests to model SDS-relevant risks such as NDs and commodity price shocks; and further strengthen coverage for contingent liabilities arising outside general government.[45]

99. The ability to apply tailored shocks as a supplement to standard shocks has broadened and enriched analysis of the potential impacts of shocks in SDS**.** With increasing frequency, staff has drawn on various authoritative external databases on ND impacts. The use of tailored shocks now also provides an opportunity to broaden coverage of the risks to debt sustainability by incorporating the impacts of CC into DSAs, with staff now able to incorporate some form of tailored shock to reflect the adverse impact on real growth from the impacts of CC (e.g., drought, changed precipitation patterns) that occur more broadly over the medium term. Increasingly, regional climate models are affording a clearer picture of both the range of potential effects and their timing, thereby improving the prospect that the accuracy of these assessments may strengthen over time. In addition, through this process, both the consequences as well as policy options for fiscal policy management have become clearer, including the merits in building up contingency funds to manage disaster expenses.

100. Notwithstanding these gains, assessment of recent SDS DSAs also suggests some gaps in the current DSA architecture and opportunities to further improve the utility of the DSA toolkit for SDS. For example, at present, the baseline scenario in most fiscal projections for SDS does not include the outlays for infrastructure maintenance or climate resilient investments warranted in the context of exposure to ND shocks or CC. This is an important omission, as the absence of such necessary spending effectively aggravates the country's potential risk exposure to damage in the event of a ND shock. Adjusting the DSA framework to provide for these outlays in the baseline scenario would be appropriate, would strengthen the framework itself, and could be facilitated by wider application of CCPA.

101. There is also further scope to amplify assessment of the implications for debt sustainability and in turn fiscal policy, in the event that more than one severe shock, as well as different types of shock (for example ND and shocks related to CC or pandemics) affects a country over the medium term. The recent COVID-19 pandemic has shown that the risk of multiple shocks cannot be excluded and that unanticipated or relatively infrequent sources of risk cannot be ignored. Current RAMs recognize the potential anticipated sources of risk (e.g., frequent but low

[45] It also provides optional tools for risks from population aging, natural resource discovery/depletion and CC—all of which are relevant for SDS countries.

damage NDs, a recession in a key partner country, a slump in export prices or a rise in key import commodities). Some tail risk events, such as a catastrophic storm, are now regularly taken into account. Others, however, such as a pandemic or a global financial crisis, are rarely treated as risks of concern. CC risks are treated more on an historic basis and only with recent CCPAs has there been inclusion of more forward-looking assumptions that reflect CC risks intensifying in their magnitude and frequency. As noted above, some DSA analyses seek to appraise the consequence of combined shocks or of tail risks with suitably significant effects. The latter in particular has begun to motivate policy with respect to buffer funds or risk transfer mechanisms. With the benefit of hindsight, it is clear that in DSA's completed over the past decade the probability of most such combined risks was not seen as significant enough to motivate a sufficiently high policy priority on the build-up of a financially resilient fiscal position, whether in terms of the accumulation of financial assets or achieving much lower level of public debt.

102. For many SDS, the COVID-19 pandemic vividly illustrates this possibility. While the current DSA methodology allows for the possibility of combined shocks, it is increasingly important to introduce this approach more systematically in SDS DSAs, particularly in assessing risks in the context of multiple shocks and in the treatment of climate-related shocks. There are precedents. The MAC DSA framework usefully includes a "heat map" that characterizes (in different colours) the degree of debt vulnerability that would be associated with different risks. This approach could be adapted for SDS, for example by including a standardized text box in DSAs on the fiscal consequences, were several severe risks to materialize simultaneously.

103. A second concern is that while the LIC-DSF allows for accounting for sufficiently liquid government assets to inform staff judgment in the final assessment, DSAs reviewed for this evaluation did not, in practice, take adequate account of SDS' readily available financial or natural resource assets. In line with the guidelines, DSAs focus on gross debt exposure, providing an important but not comprehensive perspective on SDS' fiscal position, particularly in several Caribbean SDS where various ND or heritage funds provide an important cushioning effect on their debt vulnerability. This is similarly the case in several Pacific SDS, whose sovereign wealth funds substantially exceed their outstanding debt (but where there are legislative constraints on the purposes for which such funds can be used). The review of Sovereign Risk and Debt Sustainability Framework for Market Access Countries (IMF, 2021) listed integrating liquid assets in a more standardized way as a possible improvement and noted some customizations in tools, such as the GFN module and the near-term risks module while still relying on staff judgment in final assessment due to data limitations.

104. There is scope to include in the DSA framework treatment of risks from significant underfunding of social insurance systems in SDS. Several SDS face this challenge, including Suriname, Dominica, Grenada, Mauritius, Marshall Islands and Micronesia. Though typically raised

in staff reports, these contingent liabilities are typically not explicitly highlighted in DSAs.[46] However they should be addressed here, as they reflect financial issues that will have to be ultimately addressed through policy reforms. The pressure on the reserves of these systems is typically felt over the longer term and not within the medium term covered by the DSA framework.

105. Similarly, given their relatively limited time horizon, DSAs have not adequately considered the opportunities and risks to debt sustainability and implications for fiscal policy, from alternative approaches to greater economic diversification. For example, heavy investment in improving transportation infrastructure or digital connections will have implication for public debt loads. On the other hand, greater economic diversity in SDS can both broaden the fiscal base and ultimately reduce the extent of the risks imperilling debt sustainability.[47] However, scenario analysis in DSAs to assess the impact of progress towards diversification has been limited. More frequent use of inbuilt flexibilities, both in the LIC DSF, which provides scope to extend the time horizon beyond the 10-year standard forecast horizon, to capture long-term risks, and the Sovereign Risk DSF, which includes a long-term module to capture these risks, can strengthen treatment of these opportunities and risks to debt sustainability.

106. Finally, the experience of many microstates suggests that providing the debt data required for the DSA exercise may be challenging, given their limited human capital. This particularly applies to the borrowing of SOEs or loans from private or bilateral creditors for the financing of government investments. Simplification of the DSA framework for these microstates could help to alleviate pressure on authorities to contribute these assessments, while retaining the core benefits derived from the periodic DSA exercise, including formal monitoring of the most important risks and threats to the projected fiscal path precipitated by unanticipated debt accumulation. A linkage of the DSA work in the context of surveillance with the application of other fiscal risk assessment management tools (both of the IMF and World Bank) may be particularly valuable in mitigating climate-related debt vulnerabilities.

VIII. RESPONDING TO THE COVID-19 PANDEMIC

A. The Fund's Response in Relation to SDS

107. Most SDS spent the 2010–2019 decade seeking to reduce a heavy public debt load. Some sought to acquire some degree of financial resilience to absorb new shocks related to CC or global developments. Yet, the COVID-19 pandemic has been an enormous setback, with at least half of SDS experiencing a fall in GDP and fiscal balances of about 10 percentage points and

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[46] The 2019 DSA for Mauritius is an exception (Mauritius AIV, 2019). The DSA explicitly notes that "population aging will put greater financial pressures on the country's pension system."

[47] Here the 2019 DSA for the Solomon Islands is notable. The Fund and World Bank, after evaluating the impact of a natural disaster and real growth shock, underscored the need for new sources of growth to ensure long-term debt sustainability.

5–10 percentage points, respectively in 2020. Once the global nature of the crisis became apparent by mid-March 2020, Fund staff quickly engaged in discussions with country authorities to assess the potential economic and financial impact. By end-July 2020, the Executive Board had approved access to IMF resources to 16 of the SDS, through the two emergency financing facilities, RCF and RFI.[48] As of end-April 2021, the most affected countries were largely those with significant tourist sectors heavily dependent on North American and European markets. SDS principally reliant on commodity exports (oil, minerals, the maritime sector, and agriculture) and those with remote international linkages (particularly in the Western Pacific) did not experience the same degree of dislocation as a result of the pandemic and most did not seek Fund financing.

108. The nature of the Fund's involvement can be briefly characterized. First, the Fund sought to quickly provide access to significant financial resources in the context of macroeconomic policy support to help deal with the needs for additional health spending and the negative shock to the economy. Although disbursements were upfront with no ex post conditionality, a country seeking access to emergency financing needed to lay out in a letter of intent the general policies it plans to pursue to address its BOP difficulties consistent with debt sustainability, how its policies advance its poverty reduction and growth objectives, and its intention not to introduce measures or policies that would compound its BOP difficulties. The letter of intent underpins staff's assessment of economic prospects to help catalyze support from other international donors (since the Fund's financing rarely provided more than a quarter of the financing gap that had suddenly become apparent). These letters of intent (available on the IMF website) covered not only macroeconomic policies but also policies to provide safeguards aimed at ensuring good governance and appropriate use of the resources for intended purposes. Staff reports in support of financing requests:

- described the country's policy actions in response to the crisis—the efforts to limit the spread of the virus through the closure of borders, stay-at-home requirements, business and school closures, testing and tracing efforts, and treatment efforts; and

- characterized the impact on the macroeconomy and debt prospects for 2020 and beyond, including, for the fiscal sector, the effects on revenues, budget allocations, and financing; and strongly underscored the significant uncertainties in these forecasts and the downside risks in particular (both from the relevant global effects of the crisis and on the effects that might arise were there to be an expanded local outbreak in a country).

109. Fiscal policy issues were at the center of the challenges faced by SDS as a result of the pandemic. Particularly for tourism dependent SDS, the dramatic impact on their dominant economic sectors led to a substantial decline in government revenues while impelling government efforts to finance both the heightened demand on the health sector and the need to

[48] Maret (2022).

offer financial assistance to support vulnerable population groups and those suddenly rendered unemployed. Similar fiscal effects were faced by SDS with natural resources as a result of the adverse effects on commodity prices due to the pandemic-induced global slowdown (Baunsgaard and others, 2020). Efforts to contain the unanticipated fiscal financing gap revolved around measures to cut the government's wage bill, often with the support of trade unions, limit less essential current expenditure, and reprioritize planned capital investments. The latter proved challenging for many SDS, as some ongoing externally financed projects were seen as growth critical and their financing was earmarked, while many domestically financed projects were deferred. Containing transfers to SOEs was recognized as critical but challenging, as subsidizing utility prices were often an instrument for social support. For most countries, the Fund's financial support flowed directly to the budget (through the Central Bank).[49] Domestic financial support was sometimes realized from government pension institutions, including foregoing worker's pension contributions or drawing on accumulated pension savings) and from the government's own liquid assets. In many cases, authorities underscored the binding impact of a lack of fiscal space to respond to the crisis, compared with the greater short-term budget support observed in wealthier economies (see evidence presented in March 2021).

110. Staff reports supporting emergency financing requests highlighted the adverse impact of the shock on fiscal resilience. In concert with the authorities and based on their previous work, the staff underscored the consequences of the crisis for the authorities' previously expressed medium-term fiscal goals—in particular, the delays likely in realizing previously set public debt targets as well as the additional fiscal consolidation efforts, in terms of the increased necessary primary balance, that would be necessary once the COVID-19 crisis had passed. Given the limits perceived on how feasible would be additional fiscal consolidation actions, most countries seeking Fund support initially anticipated delays of 2–6 years in achieving previously declared debt targets.[50] And for those countries at risk of ND&CC, the worsened vulnerability of the sudden rise in public debt implied accentuated difficulties in acquiring financial and physical resilience through the budget and the capital investment program.[51] In some cases, the staff

[49] Most program documents explicitly note that the budget would have direct access to the Fund's financial support through the Central Bank.

[50] The DSAs prepared in the context of their request for Fund resources highlighted the potential deterioration in the debt-to-GDP ratios, reflecting assumptions at that time on how long the crisis would persist. For the four Caribbean SDS, the increase in the projected ratio during the immediate fiscal period (whether 2020 or 2020/21) ranged from 5 percent of GDP to a high of 21 percent in The Bahamas, with some further increase in the ratio projected over a medium term of 5 years; among Pacific Island states, from 7 percent of GDP in the Solomon Islands to 15 percent of GDP in Samoa; in African SDS, from 6 percent of GDP in the Union of the Comoros to as high as 26 percent of GDP in the Seychelles; in Montenegro and Djibouti, 11 percent and 8 percent of GDP, respectively.

[51] Previous DSA analyses were typically updated, highlighting the shock and delays to the debt trajectory but given the assumption that the shock would pass within a limited time frame and, assuming a reasonably quick recovery to past economic conditions, there were no changes in the assessment of debt vulnerability.

underscored the desirability of formulating ex ante fiscal contingency plans that would facilitate an effective fiscal response to a future exogenous shock.

111. Furthermore, staff reports supporting this emergency financing underscored the important structural issues that would need to be tackled if an efficient and effective fiscal response to the COVID-19 pandemic were to be secured, particularly on the expenditure side. Most of these issues reflected numerous longstanding challenges identified in past surveillance, on the expenditure side, with many already the focus of ongoing CD from the IMF and other multilateral institutions, though made more difficult in the COVID-19 environment. These include weaknesses in PFM (particularly in budgeting), inefficiencies and inflexibilities in the budgeting and implementation of public investment projects, difficulties in the monitoring and management of SOEs, inadequacies in the targeting of subsidies and social assistance, and continuing problems in governance and transparency.

112. Responding to these challenges, FAD prepared detailed COVID-19-related advice in the form of "How-To" notes on the range of fiscal issues that SDS and other members are likely to encounter, all of which were made available on the IMF's public website: Special Series on COVID-19. These notes address revenue, expenditure, fiscal management, and social welfare issues.[52] Additionally, two "How-To" notes provide practical guidelines on operational fiscal management issues: (i) developing and implementing a cash buffer policy to manage the government's liquidity position (Hürcan and others, 2020), and (ii) the management of public investment during a postcrisis recovery (Tandberg and Allen, 2021). The Strategy, Policy, and Review Department also issued a "How-To" note discussing important questions for both Fund staff and member states to consider in operationalizing the Fund's engagement on social spending policies both during and in the aftermath of the COVID-19 crisis (Murgasova and others, 2020).

B. Fiscal Lessons from the COVID-19 Crisis

113. In the initial phase of the epidemic (though the summer of 2020), the Fund responded quickly and appropriately to the urgent need of SDS countries to the financial challenge caused by the COVID-19 crisis. It provided valuable advice and financial support for fiscal policies in SDS to meet their urgent health and economic needs. By focusing financial support through the

[52] Specifically, the notes address such issues as addressing the expenditure policy challenges in providing temporary relief for firms and households, ensuring transparency in emergency responses to the pandemic, guidance on health spending policies, assessing the role of universal transfers, the challenges of reaching households in need of assistance, gender equality impacts of the pandemic, strengthening tax policy and administration, the role of recovery contributions from high income and wealthy individuals, the role of COVID-19 funds created to respond to the pandemic, the impact on pension schemes, expenditure policies dealing with food insecurity, challenges for the fiscal budget in 2021, methods to mitigate corruption in budget execution during the pandemic, the impact on fiscal rules, challenges in cutting public wages in the context of reshuffling expenditure, addressing the impact on natural resource fiscal regimes. The material is available at https://www.imf.org/en/Publications/SPROLLs/covid19-special-notes#fiscal.

Fund's emergency facilities, it did not require the country to address the serious policy reforms that would normally be required in an upper credit tranche program. However, for SDS most affected by the COVID-19 pandemic, the challenges are continuing. A recent staff paper (Goretti and others, 2021) highlights that the pandemic has been a setback that will take several years to overcome in terms of lost output and higher debt. And for many SDS with limited economic diversity, prospects are more dire particularly if there is a prolonged slump in export demand. Here, as noted in the previous paragraph, the Fund has actively sought to provide guidance on the critical fiscal policy challenges facing most SDS and other members as the crisis has continued through 2021.

114. Four key lessons emerge for the Fund's fiscal engagement with SDS going ahead. First, SDS will now be far weaker in terms of their base level of resiliency, with the crisis having eroded contingency budgets and resiliency funds, and added to their stock of debt, putting them more at risk if confronted by a future ND. This will create severe fiscal challenges that will require a revisiting of SDS tax systems, tolerance of inefficient and costly SOEs, government employment policies, and the generosity of civil service pension systems.

115. Second, the Fund's emphasis that lower income SDS should avoid non-concessional debt financing becomes even more important. SDS have leaned strongly towards ambitious infrastructural investment programs financed by non-concessional debt. While some investments have been motivated to achieve greater resiliency to the effects of CC (resettlement of populations exposed to sea level rise), others have sought to expand their tourism market potential (e.g., enlargement of airport terminals). The returns from such investments may now fall well short of those anticipated.

116. Third, the COVID-19 crisis has dramatically increased explicit public debt levels while eroding private sector assets. While the magnitude of the financial need of the SDS is relatively small by international standards, the IMF may need to play a more forceful role in catalysing support for these countries in exchange for a much greater emphasis on policy reforms, including stronger emphasis on accumulation of buffers rather than reduced debt levels.

117. Finally, the appropriate level of savings needed to foster fiscal resiliency in the face of potentially large periodic shocks may need to be reassessed. Recent staff papers on ND risks and CCPAs (Dabla-Norris and others, 2021; IMF, 2020) highlight an important distinction between: (i) programs of investment and adaptation that enhance resiliency by reducing the damages likely to be caused by NDs (such as, but not limited to "fast-moving" climate shocks, such as hurricanes/typhoons or locust infestations and "slow-moving" climate shocks associated with excessive drought or unanticipated patterns of precipitation); and (ii) a building up of resilience fund assets to address reconstruction and recovery outlays in the event of a ND. Staff have begun to urge countries to explicitly budget for the latter (at an annual rate that would cover the cost of a ND occurring at historic frequencies (or that suggested by the pace of CC) (e.g., Belize 2019 AIV; Dominica 2018 AIV; St. Lucia 2018 AIV; Solomon Islands, 2018 AIV), but not the former. The potential for future periodic shocks of COVID-19 dimensions has not been

factored into staff recommendations. Staff research also questions whether countries should explicitly incorporate private risk transfer mechanisms that would address large NDs, given the high cost of such mechanisms. This raises the question of whether countries should rely on the good will of larger countries in the event of catastrophic NDs.

IX. Findings and Conclusions

118. The background paper has assessed how well the Fund staff responded to both the changing environment and the changing perception of the fiscal policy issues confronting a group of countries faced by common challenges of "smallness" but nevertheless differing in many fundamental ways.

119. Until 2014, IMF staff did not explicitly differentiate their approach to analyzing fiscal policy in SDS economies from that used for other IMF members. But the subsequent years saw significant changes in how the IMF staff analyzed and provided advice on the fiscal challenges faced by SDS. Four changes were particularly noteworthy. First, many SDS were subject to dramatic NDs, mostly in the form of hurricanes and cyclones, that overturned the fiscal strategies of the affected countries. Increasingly, the Fund recognized that environmental forces would make such events more frequent and intense, necessitating a serious rethinking of what would be required to achieve fiscal resilience. Second, new policy research shed further light on the unusual and distinctive economic challenges faced by such small economies, highlighting the need for a more calibrated approach that took account of the unique policy challenges faced by SDS. By 2014, the IMF reflected this need for a differentiated approach in its first Staff Guidance Note on the Fund's Engagement with Small Developing States; further refinements were made in a revised 2017 Guidance Note. Third, some SDS introduced policy innovations in mobilizing government revenue that influenced the nature of their fiscal policy dialogue with the Fund. And finally, an even more unanticipated disaster—the COVID-19 pandemic—transformed the economic landscape of many SDS.

120. The documentary evidence makes it palpably clear that the IMF put in an enormous effort, particularly in the latter part of the evaluation period, in its work to address the particular fiscal problems faced by SDS. The evolution in the intensity and increased prioritization is manifest from Fund research efforts, the quantity and quality of surveillance analyses, the intensity of CD engagement and most importantly, from the new thinking embodied in the recent staff papers and Staff Guidance Notes related to SDS. The staff displayed enormous perseverance in seeking to help countries make progress on fiscal resilience and debt sustainability in the face of ND and pandemic setbacks that have gone beyond what risk assessment matrices would have anticipated.

121. The last half decade reveals the critical role that the Fund has played on fiscal policy in SDS by its direct engagement through surveillance, program work and CD. These efforts provided SDS with policy guidance, conceptual tools and detailed technical advice for managing and strengthening their fiscal policies and responding to the multiple challenges of CC, equity

disparities, and human capital limitations. The body of policy advice provided was abetted by the significant implicit CD support that it embodied. For SDS with limited managerial experience and capacity, operational CD work played a key role in supporting surveillance and program work incorporating the benefits of the Fund's experience with other countries, and external research findings. Whereas much of the policy guidance provided by CD on "bread and butter" fiscal issues (PFM, tax policy, revenue administration, and expenditure policy) could be said to draw on years of FAD policy practice, much of the thinking on managing the risks of ND&CC and the fine tuning of much of the macro fiscal issues for the SDS context evolved in real time. In addition, the RCDCs played an important role in providing continuing on-the-ground advice to support implementation and build communities of practice on fiscal issues.

122. The other body of fiscal "education" provided by Fund staff took place in the context of both organizing fiscal data in a conceptually meaningful format and in the preparation of alternative medium-term fiscal scenarios, risk assessment matrices, and DSAs with increasing attention to SDS vulnerabilities, including SOEs and CC. The latter not only clarified the baseline position implied by government policies but also suggested the impact of more active policies including key structural policy reforms. That said, while recognizing the substantial progress made, there are some gaps, including adequate treatment of the multiple exogenous shocks to which SDs are prone.

123. At a minimum, this kind of analytic work at the Fund and its translation into SDS analysis and advice is gradually enhancing the ability of local SDS economists to understand better the challenges and potential risks to be confronted. It is easy to underestimate how much this material stretched local officials working in SDS (compared to larger countries with much greater analytic capacity). But again, the efforts to date have exposed structural issues that will need further work by SDS in managing their finances, notably regarding asset-liability management for countries with significant sovereign wealth funds and natural resource endowments. Again, the pandemic has only worsened the state of these finances. The recent proposal to provide debt management experts in the Caribbean and Pacific RCDCs provides critically necessary institutional support, particularly with regard to judgments on fiscal risk exposure.

124. More broadly, the extent of traction of the Fund's fiscal work on SDS during the evaluation period has been mixed. The absorption of Fund policy advice by the small cadre of fiscal economists working on SDS, not to mention politicians and parliamentarians, was inevitably bound to be a slow process. By virtue of the relative infrequency of Fund consultation missions and the dominance of operational work by SDS finance ministry officials relative to the time available to absorb new ideas or implement new processes, policy action and institutional strengthening was halting and uneven. While the combination of heavy debt and looming CC issues should be sufficient to motivate more intense action, ultimately political economy factors, and the challenge of the day-to-day tasks dominate their fiscal focus at the expense of longer-term consolidation. The pandemic has certainly aggravated these obstacles.

125. If the criterion for achieving fiscal resiliency is a clear reduction in the debt-to-GDP ratio over the decade, the facts would suggest that the Fund's surveillance efforts during the evaluation period were not very successful. But such a simplistic judgment (even before the pandemic struck) would neither take account of the setbacks experienced by several countries due to ND shocks nor of the counterfactual of what their debts would have been absent the IMF's involvement. An examination of revenue and expenditure trends might provide at least some evidence that the Fund's efforts (along with those of other international organizations) promoted and enabled reforms that have allowed for the creation and better management of the available fiscal space.

126. Finally, the IMF's discussions on CC have laid the groundwork for meaningful integration of issues of climate-related NDs into fiscal policy discussions. Far more frequent now are calls by the staff that annual budget contributions should reflect the expected annual costs to the budget for relief and reconstruction that can be expected from anticipated typical (and manageable) climate events (though it remains to be seen whether many governments now actually include such contributions in their annual budgets). A number (though not all) of Caribbean and Pacific governments have also sought coverage for less frequent but more catastrophic events under two private sector risk transfer mechanisms, the Caribbean Catastrophe Risk Insurance Facility and the Pacific Catastrophic Risk Assessment and Financing Initiative. While the IMF cannot fully take credit for these actions (given the involvement of other multilateral institutions), its recent efforts to produce CCPAs at least contributes to the overall discussion.

127. But the challenges to SDS from CC for fiscal policy and sustainable development are still not consistently reflected in the Fund's surveillance advice, leading to the issues not being addressed in consultations with some potentially vulnerable countries. Moreover, NDs are only the leading edge of environmental effects which will further compromise SDS fiscal positions. Adaptation initiatives will be required to address such daunting challenges as sea level rise, coral bleaching, changing maritime temperatures affecting fisheries, and changing precipitation patterns) as the effects of CC intensify in coming decades. Even those non-island SDS with natural resources will, over time, confront pressures from global mitigation efforts and the impact of rising temperatures on water resources.

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